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RESTRUCTURING MUNICIPAL BANKRUPTCY

Laura Napoli Coordes*

Abstract

What sorts of legal relief should be available to a municipality in financial distress? Chapter 9 of the Bankruptcy Code has served as an option of last resort for many municipalities over the years. But as this Article illustrates, Chapter 9 arguably falls short of an effective solution and at times seems to contravene the foundational principles underlying bankruptcy law. By examining recent Chapter 9 filings, this Article presents a comprehensive analysis of how and why Chapter 9 has failed to address the problems that characterize municipal insolvencies. It argues that Chapter 9, in both practice and principle, has proved unsatisfactory in combating the very issues it was designed to resolve. After highlighting Chapter 9's shortcomings, this Article suggests critical areas of reform that will begin to reconcile Chapter 9 with the broader goals of bankruptcy law.

I. INTRODUCTION

In sunny California, a city is struggling. Crime is up, and infrastructure improvements are down.¹ In 2013, “there were more than two dozen homicides compared to just seven in 2006.”² “Residents are leaving.”³ City officials expect pension payments to jump to over 20% of the city’s budget, putting the city into a “death spiral.”⁴ Moody’s Investors Service has concluded that the city “remains vulnerable to increasing annual [pension] payments.”⁵

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¹ Irma Widjojo, *Vallejo Homicide Numbers Highest in Nearly 20 Years*, TIMES-HERALD (Jan. 2, 2014, 12:01 AM), <http://www.timesheraldonline.com/general-news/20140102/vallejo-homicide-numbers-highest-in-nearly-20-years> [<http://perma.cc/Y4RV-FQQN>].

² Bob Adelmann, *Vallejo, California, Likely Headed for Second Bankruptcy*, NEW AM. (Mar. 17, 2014), <http://www.thenewamerican.com/economy/sectors/item/17865-vallejo-california-likely-headed-for-second-bankruptcy> [<http://perma.cc/WHJ6-4XTB>].

³ *Id.*

⁴ *Id.*

⁵ *Bankrupt California Cities Face Steep Climb to Solvency Without Pension Relief*, MOODY’S INV. SERV. (Feb. 20, 2014) (internal quotation marks omitted),

This city may seem like a prime candidate for municipal bankruptcy under Chapter 9 of the Bankruptcy Code. But in fact, this city has already filed for Chapter 9 and emerged from bankruptcy less than five years ago.⁶ This city is Vallejo, California, and it faces a very real risk of tumbling back into the financial distress Chapter 9 was supposed to help alleviate.⁷

Over the past few decades, counties, cities, and towns have turned to Chapter 9 to adjust their debts and to receive a fresh start that enables them to better address other issues, such as rising crime or failed infrastructure projects.⁸ On paper, Chapter 9 provides distinct advantages to a struggling municipality, including breathing room to assess its situation free from the pressures of creditors, the ability to renegotiate contracts, and an opportunity to formulate a plan of adjustment to deal with debts.⁹ In practice, however, entities utilizing Chapter 9 face expensive, time-consuming, and resource-draining battles that often prevent them from achieving the very outcomes they seek from bankruptcy.¹⁰

Overwhelming pension shortfalls, poorly structured financing deals, and the aftermath of the economic recession are leading more municipalities to consider bankruptcy as an option for dealing with financial distress.¹¹ A close look at the Chapter 9 cases filed over the last few years indicates, however, that Chapter 9 has often been unable to help municipalities achieve the goals they seek from bankruptcy, notably, elimination of holdout creditors and reduction of debt overhang.¹² By focusing on these recent municipal bankruptcy cases, this Article draws attention to Chapter 9's limitations and demonstrates that Chapter 9, as currently used, often undermines the very objectives it is designed to help municipalities accomplish.

https://www.moodys.com/research/Moodys-Bankrupt-California-cities-face-steep-climb-to-solvency-without--PR_293349 [<https://perma.cc/Z67P-PMEW>].

⁶ *Id.*

⁷ *Id.*

⁸ See Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 470 (1993) (noting that “municipal bankruptcy is based on the idea of the fresh start”).

⁹ See JONES DAY, AN OVERVIEW OF CHAPTER 9 OF THE BANKRUPTCY CODE: MUNICIPAL DEBT ADJUSTMENTS 11 (2010), <http://www.jonesday.com/files/Publication/d518067b-5e02-47c5-9768-fc692bb8ccd8/Presentation/PublicationAttachment/55c686be-d108-4786-ae66-de946542d3da/Chapter%209%20Municipal%20Debt.pdf> [<https://perma.cc/CF9A-LTK2>].

¹⁰ *Id.*

¹¹ *Id.* at 3.

¹² Although it is admittedly difficult to find consensus among scholars on the goals of municipal bankruptcy, the literature in this area consistently speaks of bankruptcy as a mechanism to eliminate holdout creditors and reduce debt overhang, the condition where an entity's debt is so significant that it cannot easily borrow money that would help it get out of debt. This literature is described in greater detail in Parts III and IV, *infra*.

This Article provides a thorough analysis of recent municipal bankruptcies to assess exactly how and why Chapter 9 is failing our cities and towns.¹³ Chapter 9 was modeled off of Chapter 11 of the Bankruptcy Code, and this Article demonstrates that Chapter 11's tools are often an ill fit for the municipalities Chapter 9 is intended to help. In addition to describing Chapter 9's practical shortcomings, this Article shows that Chapter 9 commonly leads to results that are inconsistent with a coherent vision of bankruptcy law.

Although the academic literature to date has acknowledged many of Chapter 9's shortcomings,¹⁴ Chapter 9 is still considered by many to be an appropriate, if tedious, method of addressing municipal financial distress.¹⁵ This Article bolsters the arguments against that view¹⁶ by providing a critical analysis of Chapter 9's

¹³ This Article's focus is on cities, towns, counties, and other general-purpose entities, as distinguished from special-purpose districts and school districts. Although the latter are frequently considered to be municipalities that can file for Chapter 9, the unique struggles of the general-purpose municipal bankruptcies that have been filed over the past few decades are this Article's primary focus. A full discussion of the differences between special- and general-purpose bankruptcies is beyond this Article's scope; however, Part IV, *infra*, contains recommendations for tailoring Chapter 9 relief more closely so as to distinguish the needs of general-purpose and special-purpose entities.

¹⁴ See, e.g., Christine Sgarlata Chung, *Zombieland/The Detroit Bankruptcy: Why Debts Associated with Pensions, Benefits, and Municipal Securities Never Die . . . and How They Are Killing Cities like Detroit*, 41 *FORDHAM URB. L.J.* 771, 813 (2014) ("Even when municipal bankruptcy (and debt adjustment) is available, it is not a 'cure-all,' especially for taxpayers and public workers."); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 *U. CHI. L. REV.* 281, 287 (2012) ("The current legal structure for addressing municipal fiscal distress may interfere with, rather than advance, the objectives of fiscal federalism . . ."); Katherine Newby Kishfy, *Preserving Local Autonomy in the Face of Municipal Financial Crisis: Reconciling Rhode Island's Response to the Central Falls Financial Crisis with the State's Home Rule Tradition*, 16 *ROGER WILLIAMS U. L. REV.* 348, 358 (2011) ("Overall, then, Chapter 9 bankruptcy provides an incomplete solution to the problem of municipal insolvency."); McConnell & Picker, *supra* note 8, at 479 ("It may well be . . . that federal municipal bankruptcy law is even more fundamentally misconceived than at first appeared . . .").

¹⁵ See, e.g., Ryan Preston Dahl, *Collective Bargaining Agreements and Chapter 9 Bankruptcy*, 81 *AM. BANKR. L.J.* 295, 298 (2007) ("The availability of bankruptcy-specific rights is of heightened importance to the municipal debtor."); Henry C. Kevane, *Deploying the "Prepackaged" Plan of Adjustments in Chapter 9*, in *CHAPTER 9 BANKRUPTCY STRATEGIES* 107, 109 (Jo Alice Darden ed., 2011) ("Although Chapter 9 rightly remains an option of last resort . . . it now seems more probable that municipalities will begin to use federal bankruptcy relief as an active tool to re-calibrate revenues, services and expenses."); Richard W. Trotter, *Running on Empty: Municipal Insolvency and Rejection of Collective Bargaining Agreements in Chapter 9 Bankruptcy*, 36 *S. ILL. U. L.J.* 45, 49 (2011) (noting that Chapter 9 bankruptcy is becoming an "increasingly viable" and sometimes "attractive" option).

¹⁶ See, e.g., Gillette, *supra* note 14, at 283; Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 *YALE J. ON REG.* 351, 382 (2010); McConnell & Picker, *supra* note 8, 482–83.

modern usage that specifically identifies how and why Chapter 9 harms the specific entities it is intended to help.

Unlike those who believe that Chapter 9 should be discarded, however, this Article posits that reform can make Chapter 9 a more effective solution to certain municipal problems. Thus, after explaining why Chapter 9 is not working as designed, this Article targets several areas for reform. By analyzing Chapter 9 against the broader backdrop of bankruptcy law, this Article illustrates the need to develop a Chapter 9-specific toolkit in order to give municipalities the relief they seek. Still, this Article cautions that a one-size-fits-all solution may be impractical for addressing the various problems encountered by the wide variety of distressed municipalities that rely upon Chapter 9 for relief. Indeed, Chapter 9 is ineffective in part because it does not account for most of these variations in problems and entity types. Only by acknowledging and understanding the primary shortcomings of Chapter 9 can policymakers move forward with clarifying the roles of various actors to resolve municipal distress and develop more appropriate avenues of relief. Thus, this Article begins to illuminate key areas of reform that will make Chapter 9 more effective at resolving the problems it is supposed to address.

This Article proceeds in three parts. Part II provides the necessary background on Chapter 9's development and highlights several flaws present in its design. Part III then examines one of Chapter 9's most controversial elements: stringent eligibility requirements that force debtors to expend significant time and resources just to prove that they belong in bankruptcy. Part IV uses a series of cases to illustrate exactly how and why Chapter 9 fails to work. On a structural level, Chapter 9 does not provide municipalities with the tools necessary to adjust their debts in any meaningful manner, thus rooting them more deeply into their financial problems. More broadly, Chapter 9 interferes with the goals underlying the bankruptcy system. Using these insights, Part V suggests and evaluates possible alternative avenues for relief, concluding that a rigid solution for tackling the problem of municipal financial distress likely does not exist. Instead, any solution to the municipal distress problem must be flexible enough to account for the various alternative mechanisms states already have in place, in addition to states' and cities' varying political, fiscal, and social climates. This Article concludes by encouraging more research into Chapter 9 reform while emphasizing that suggestions to bolster Chapter 9's effectiveness or supplementation of Chapter 9 with state and regional relief must begin by realigning Chapter 9 practice with basic bankruptcy theory.

II. CHAPTER 9'S DEVELOPMENT AND DESIGN

A careful examination of Chapter 9's development reveals that it is a body of reactionary law, designed to patch up impending crises, but ill-equipped to function as a broader solution to a complex and fluid set of problems. This poor fit creates unpredictability and instability in the law. To illustrate this concept, Part II focuses on one of Chapter 9's most unique structural elements: the existence of stringent eligibility requirements that force debtors already at death's door to expend substantial time and resources justifying their use of Chapter 9. Specifically, section

II.A traces Chapter 9's development and design, and section II.B analyzes some of the difficulties that result from the need for municipalities to comply with Chapter 9's eligibility requirements.

A. Development

Chapter 9 began as a response to the Great Depression, a time when thousands of municipalities defaulted.¹⁷ In 1933, Congress amended what was then the Bankruptcy Act to enable cities and towns to adjust debts that were becoming overwhelming.¹⁸ Although these entities could theoretically have adjusted their debts without federal assistance,¹⁹ they typically faced a holdout creditor, an entity that refused to agree to the adjustment, even though most others were on board. By allowing a bankruptcy judge to approve debt adjustments agreed upon by a supermajority of creditors (rather than a unanimous vote), Congress alleviated the holdout creditor problem.²⁰

Bankruptcy law is uniquely used to overcome holdout creditor problems because contracts cannot be modified on a nonconsensual basis under state law.²¹ Instead, only federal law gives entities the power to modify or terminate contracts over objections.²² Bankruptcy law also counters the collective action problem that results when creditors pursue their individual interests with respect to a distressed debtor by providing for a single, collective process for debt resolution.²³ Thus, it was reasonable for Congress to seek bankruptcy remedies for holdout creditors and collective action problems plaguing municipalities.

¹⁷ Daniel J. Freyberg, *Municipal Bankruptcy and Express State Authorization to Be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency—and What Will States Do Now?*, 23 OHIO N.U. L. REV. 1001, 1002 (1997); Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 923 (2012) (“Chapter 9 municipal bankruptcy in the United States came about partly in response to creditor holdout behavior that blocked municipal debt adjustment, as well as a spate of lawsuits against municipal officials during the Great Depression.”).

¹⁸ Vincent S.J. Buccola, *Who Does Bankruptcy? Mapping Pension Impairment in Chapter 9*, 33 REV. BANKING & FIN. L. 585, 592 (2014).

¹⁹ Indeed, prior to 1934, municipalities did not have federal assistance with debt adjustment. KENNETH N. KLEE, *A SHORT HISTORY OF MUNICIPAL BANKRUPTCY* 1 (2012), <https://cumberland.samford.edu/files/Short%20History%20of%20Municipal%20Bankruptcy.pdf> [<https://perma.cc/XP6A-7BEE>]. This meant that creditors had only state law rights (such as filing a mandamus action), and that municipal debt adjustment was limited by the Contracts Clause of the Constitution. *Id.*

²⁰ Buccola, *supra* note 18, at 592–93.

²¹ See McConnell & Picker, *supra* note 8, at 450.

²² See *id.* (noting that state law was insufficient to remedy the holdout creditor problem).

²³ See Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1190 (2014); see also David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 682 (2012) (“[M]ost American bankruptcy scholars have understood bankruptcy as a response to collective action problems . . .”).

The Supreme Court, however, was not convinced, and in 1936, the Court declared Congress's amendments an unconstitutional encroachment on state sovereignty.²⁴ In *Ashton v. Cameron County Water District*,²⁵ the Court expressed concern that the national government, through the Bankruptcy Act, was inappropriately interfering with the obligations of state political subdivisions, in contravention of the Tenth Amendment, which reserves undelegated powers to the states.²⁶ Specifically, the Court held the federal government could not use the Constitution's bankruptcy clause to impair state powers or to pass any laws inconsistent with the idea of state sovereignty.²⁷ The Court noted that the federal government was improperly intruding into the state's internal, commercial affairs by interfering with municipalities' contractual obligations.²⁸ In short, by allowing municipalities to take advantage of federal laws to adjust their debts and contracts, the amendments, according to the Court, impermissibly invited intrusion of the federal government and federal laws into state financial affairs.

The Court's ruling in *Ashton* proved only a minor setback. In 1937, Congress revisited the Bankruptcy Act and enacted amendments very similar to those the Court had struck down.²⁹ This time, however, the Supreme Court upheld the amendments.³⁰ The Court's somewhat puzzling change of heart may perhaps be explained by changes in economic climate³¹ or in the composition of the Court,³² but the revised amendments also provided more limited powers for the bankruptcy court in municipal cases, potentially alleviating the Court's concern about federal government intrusion into state affairs.³³ Despite its earlier reservations, in *United States v. Bekins*,³⁴ the Court upheld these new amendments and seemed to accept the

²⁴ *Ashton v. Cameron Cty. Water Improvement Dist. No. One*, 298 U.S. 513, 527 (1936).

²⁵ 298 U.S. 513 (1936).

²⁶ *Id.* at 531.

²⁷ *See id.* at 530–31. Specifically, the Court expressed concerns that allowing municipalities to declare bankruptcy would permit the federal government to interfere with states' and municipalities' contractual obligations, thus prohibiting them from managing their own affairs. *Id.*

²⁸ *Id.* at 528; *see* Eric W. Lam, *Municipal Bankruptcy: The Problem with Chapter 9 Eligibility—A Proposal to Amend 11 U.S.C. § 109(c)(2)(1988)*, 22 ARIZ. ST. L.J. 625, 628 (1990).

²⁹ Lam, *supra* note 28, at 628.

³⁰ *United States v. Bekins*, 304 U.S. 27, 51 (1938).

³¹ *See* Lam, *supra* note 28, at 629 (noting that the Court “referr[ed] to the ‘steadily deteriorating economy of the early 1930s’” in its decision (citation omitted)).

³² *See* Freyberg, *supra* note 17, at 1003 n.22 (describing the justices who made up the Court in both *Ashton*, 298 U.S. 513 (1936), and *Bekins*, 304 U.S. 27 (1938)).

³³ Jonathan J. Spitz, *Federalism, States, and the Power to Regulate Municipal Bankruptcies: Who May Be a Debtor Under Section 109(c)?*, 9 BANKR. DEV. J. 621, 623 (1993) (stating that “Congress was cognizant . . . of the potential constitutional problems that existed in the exercise of federal court jurisdiction over an agency or instrumentality of a state and was careful to avoid interfering with the powers reserved to the states . . .”).

³⁴ 304 U.S. 27 (1938).

idea that the federal bankruptcy system could provide valuable relief for distressed municipalities.³⁵ By limiting the powers of the bankruptcy court, Congress successfully struck a balance between allowing federal relief and protecting state sovereignty.

Although Congress initially intended these amendments, referred to as Chapter IX of the Bankruptcy Act,³⁶ to be a temporary measure to cabin the harms of the Great Depression, in 1946, Congress permanently incorporated the amendments into the Bankruptcy Act.³⁷ In the 1970s, Congress revised the Bankruptcy Act and sought to make it easier for larger cities to file for bankruptcy relief.³⁸ New York City was facing serious financial difficulties during this time, and Congress wanted New York and other large cities to be able to utilize Chapter IX.³⁹ Thus, Congress expanded the types of debt that could be adjusted and expanded the scope of the municipality's powers in bankruptcy to respond to New York's financial crisis.⁴⁰ Despite these revisions, New York City received a bailout and did not utilize Chapter IX.⁴¹

The next major set of municipal bankruptcy revisions came in the 1980s, after the Bankruptcy Code had replaced the Bankruptcy Act, and Chapter IX became Chapter 9. During this time, Congress again grew concerned that a financially distressed city, this time Cleveland, could not utilize Chapter 9 effectively.⁴² Thus, Congress made adjustments to portions of other Bankruptcy Code chapters that had been incorporated into Chapter 9.⁴³ Specifically, Congress added provisions to Chapter 9 that gave different treatment to special revenue debt, after concerns arose that this debt could be converted into full recourse unsecured debt during bankruptcy, creating problems for municipalities like Cleveland that were restricted

³⁵ M. Heith Frost, *States As Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 829 (2015).

³⁶ At that time, Chapter 9 was called Chapter IX under the Bankruptcy Act's numbering system.

³⁷ See *In re Las Vegas Monorail Co.*, 429 B.R. 770, 778 (Bankr. D. Nev. 2010) ("In 1946, Congress made the municipal bankruptcy provisions permanent . . .").

³⁸ *Id.* at 780 (describing the specific revisions).

³⁹ Spitz, *supra* note 33, at 624–25. Specifically, the requirement that 51% (in amount) of creditors accept a plan before the bankruptcy petition was filed was impossible for cities with large numbers of creditors. *Id.* at 624.

⁴⁰ 6 COLLIER ON BANKRUPTCY ¶ 900.LH (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2015).

⁴¹ KLEE, *supra* note 19, at 6–7 (noting that the crisis in New York prompted revisions to the Bankruptcy Act and that bankruptcy for New York was averted); David A. Skeel, Jr., *When Should Bankruptcy Be an Option (for People, Places, or Things)?*, 55 WM. & MARY L. REV. 2217, 2241 (2014) (noting that, in New York City, "a bailout avoided the contagion effects that bankruptcy might have unleashed").

⁴² Mary Williams Walsh, *In Alabama, a County That Fell Off the Financial Cliff*, N.Y. TIMES (Feb. 18, 2012) (on file with the Utah Law Review), http://www.nytimes.com/2012/02/19/business/jefferson-county-ala-falls-off-the-bankruptcy-cliff.html?_r=1.

⁴³ KLEE, *supra* note 19, at 8.

from incurring recourse debt beyond a given threshold.⁴⁴ These adjustments were incorporated into the 1988 amendments to the Bankruptcy Code, yet Cleveland ultimately also avoided a bankruptcy filing.⁴⁵

In the 1990s, yet another city crisis provided the impetus for further amendments to Chapter 9. Unlike New York City and Cleveland, the city of Bridgeport, Connecticut, actually filed for bankruptcy. Yet, the State of Connecticut quickly challenged Bridgeport's authority to file for federal relief.⁴⁶ This highly publicized dispute motivated Congress to clarify the state authorization eligibility requirement in 1994.⁴⁷ To do this, Congress replaced the requirement that municipalities receive "general authorization to file" with the more stringent requirement of specific state authorization.⁴⁸

Under the old general authorization requirement, silence in the law created implicit assent to filing, but now, if no state law specifically authorizes municipalities to file, a municipality wishing to utilize Chapter 9 must seek authority from the state legislature to do so.⁴⁹ This process was designed in part to strike a better balance between federal and state authority, allowing states to have a more direct and specific say about when federal bankruptcy laws could be utilized to help struggling municipalities.⁵⁰

Congress's enactment of the specific authorization requirements in response to the Bridgeport bankruptcy further illustrates one of Chapter 9's key characteristics: its enactment and major revisions were all largely in response to crises. The measures Congress took in each version of Chapter 9 were crisis-driven, aimed at resolving a specific and pressing problem.⁵¹ Yet, the large cities that drove most of the major changes to Chapter 9 ultimately never used it, leaving the "improvements"

⁴⁴ *Id.* Specifically, lenders who lent money backed by "special revenues" could conceivably convert their debt into full recourse unsecured debt in bankruptcy, which could create problems for municipalities like Cleveland. *Id.*

⁴⁵ *Id.*

⁴⁶ JAMES E. SPIOTTO, CHAPMAN & CUTLER LLP, PRIMER ON MUNICIPAL DEBT ADJUSTMENT: CHAPTER 9: THE LAST RESORT FOR FINANCIALLY DISTRESSED MUNICIPALITIES 10 (2012), http://www.afgi.org/resources/Bankruptcy_Primer.pdf [<https://perma.cc/NV76-TMX2>].

⁴⁷ Frost, *supra* note 35, at 832.

⁴⁸ SPIOTTO, *supra* note 46, at 10.

⁴⁹ See George B. South III & Daniel G. Egan, *City of Harrisburg Chapter 9 Bankruptcy Dismissed*, DLA PIPER (Mar. 1, 2012), <http://www.dlapiper.com/en/us/insights/publications/2012/03/city-of-harrisburg-chapter-9-bankruptcy-dismissed/> [<https://perma.cc/W2PA-GSNT>].

⁵⁰ H. SLAYTON DABNEY, JR. ET AL., MUNICIPALITIES IN PERIL: THE ABI GUIDE TO CHAPTER 9, at 11–13 (2d ed. 2012).

⁵¹ See Adam Feibelman, *American States and Sovereign Debt Restructuring*, in WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 146, 186 (Peter Conti-Brown & David Skeel eds., 2012) (noting that if a crisis point is reached, "the question of amending Chapter 9 will be wrapped up in debates about how to resolve that crisis").

Congress made untested. Compounding this issue is Chapter 9's lack of originality.⁵² Chapter 9 borrows most of its provisions from other chapters of the Bankruptcy Code.⁵³ Its most prominent contributor is Chapter 11, which is designed primarily to deal with the restructuring of business entities.⁵⁴ As explored in more detail below, the organization, funding structures, and practical problems of a municipality are vastly different from those facing a corporate entity.⁵⁵ This makes it difficult for Chapter 11 rules to address municipal distress.⁵⁶

A further difficulty is that Chapter 9 applies one set of rules to a variety of entities that are vastly different in structure and function. Although this Article focuses on cities, towns, and counties, a municipality could be a hospital, a water authority, or a sewer district, to name only a few additional possibilities. Thus, one municipal entity type may look vastly different from another in terms of funding, structure, and operations.⁵⁷ Adding a further level of complexity are the many disparate types of municipal securities.⁵⁸ Finally, the underlying causes of municipal financial crises are enormously varied.⁵⁹ Thus, even though hundreds of debtors have utilized Chapter 9, the variation in entity type, funding structure, and root causes of crises makes much of the case law difficult to apply as precedent.⁶⁰

⁵² See generally DABNEY ET AL., *supra* note 50, at 41–56 (noting that several sections of Chapter 9 were borrowed from other chapters of the Bankruptcy Code).

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ See, e.g., Kimhi, *supra* note 16, at 369–72 (discussing bankruptcy for municipalities); see also Lotta Moberg & Richard E. Wagner, *Default Without Capital Account: The Economics of Municipal Bankruptcy* 14 PUB. FIN. & MGMT. 30, 31 (2014) (“With commercial corporations, there typically exists an active market for shares of ownership and there is at any moment a market value for the corporation. In contrast, there is no direct market for ownership shares of municipalities, so no market value can be established for them.”); Skeel, *supra* note 41, at 2227–28 (suggesting that municipal bankruptcy is more closely akin to bankruptcy for individuals than corporations).

⁵⁶ See Andrew L. Turscak, Jr. et al., *Settling the Municipal Landscape: How Pre-Plan Settlements in Chapter 9 May Sidestep the Traditional Claims-Resolution Process*, AM. BANKR. INST. J., May 2013, at 44, 44 (“[T]he extent to which the Code does and does not apply in [C]hapter 9 has been likened to a ‘patchwork’ or a ‘puzzle.’” (quoting *In re City of Stockton*, 486 B.R. 194, 198 (Bankr. E.D. Cal. 2013))).

⁵⁷ See Skeel, *supra* note 41, at 2220–21 (contrasting special-purpose entities with major cities); see also McConnell & Picker, *supra* note 8, at 453 (describing how Congress initially believed that counties were “on a different constitutional footing” than municipalities and therefore excluded from Chapter 9).

⁵⁸ Christine Sgarlata Chung, *Government Budgets as the Hunger Games: The Brutal Competition for State and Local Government Resources Given Municipal Securities Debt, Pension and OBEP Obligations, and Taxpayer Needs*, 33 REV. BANKING & FIN. L. 663, 688–89 (2014).

⁵⁹ See Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 638 (2008) (noting that scholars disagree over the nature and importance of factors driving a city's economic health or decline).

⁶⁰ This variation also makes it challenging for Congress to determine how best to amend Chapter 9. See generally Nicholas B. Malito, *Municipal Bankruptcy: An Overview of*

Chapter 9's development as a series of reactionary laws, combined with its broad application to a wide variety of entities, has led to an unpredictable legal system. This unpredictability erodes confidence in the bankruptcy laws.⁶¹

B. Eligibility Battles

This section explores how the balance Congress struck to preserve state sovereignty and allow for federal assistance plays out in one unique aspect of Chapter 9: the eligibility battles that municipalities must engage in to gain access to federal bankruptcy relief. Due in part to Chapter 9's unpredictability, filing for municipal bankruptcy is seen as a last resort.⁶² This typically means that any municipality seeking Chapter 9 relief is in truly desperate straits. Nevertheless, in many cases, when a municipality files a Chapter 9 case, it must embark on an arduous journey to prove that it is indeed eligible for bankruptcy relief. This process can take anywhere from a few months to several years. The eligibility battles chronicled below provide a striking illustration of Chapter 9 creditors' ability to impede access to relief and the costs involved in striking a balance between the protection of state sovereignty and the use of federal bankruptcy power.⁶³ First, however, some background information on the eligibility requirements is necessary. Accordingly, the below discussion explores: (1) the eligibility requirements, (2) the extensive eligibility fights, and (3) the harm that results.

1. Eligibility Requirements

Section 109(c) of the Bankruptcy Code lists the requirements for a debtor to be eligible for Chapter 9 relief. The municipal debtor must prove that it meets each requirement by a preponderance of the evidence.⁶⁴ In addition, § 921(c) provides

Chapter 9 and a Critique of the "Specifically Authorized" and "Insolvent" Eligibility Requirements of 11 U.S.C.A. § 109(c), 17 NORTON J. BANKR. L. & PRAC. 517 (2008) (discussing the history of municipal bankruptcy, the purpose of Chapter 9, and the lack of case law for Congress to review).

⁶¹ See Simon Johnson, *The Myth of a Perfect Orderly Liquidation Authority for Big Banks*, N.Y. TIMES: ECONOMIX (May 16, 2013, 12:01 AM), http://economix.blogs.nytimes.com/2013/05/16/the-myth-of-a-perfect-orderly-liquidation-authority-for-big-banks/?_php=true&_type=blogs&_php=true&_type=blogs&_r=1 [<http://perma.cc/H8X7-L924>] ("Once you establish special treatment and break with precedents, the entire legal process becomes murky, unpredictable and likely to spread more fear than confidence in the outcomes."). The article was referring to proposed Chapter 14 special rules for banks, but the same statement would apply equally well to Chapter 9. *Id.*

⁶² See, e.g., Kevane, *supra* note 15, at 109 (noting that "Chapter 9 rightly remains an option of last resort"); *In re Pierce Cty.*, Hous. Auth., 414 B.R. 702, 714 (Bankr. W.D. Wash. 2009) ("The legislative history indicates that the strict hurdles to filing Chapter 9 were implemented to ensure that it was considered by a municipality only as a last resort.").

⁶³ See *infra* subsection II.B.2.

⁶⁴ Melissa B. Jacoby, *The Detroit Bankruptcy, Pre-Eligibility*, 41 FORDHAM URB. L.J. 849, 851 (2014).

that the bankruptcy judge may dismiss the debtor's petition if the municipality did not file the petition in good faith.⁶⁵

(a) *The entity must be a "municipality" as defined in the Bankruptcy Code*

"Municipality" is defined in the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State."⁶⁶ Cities, towns, and counties easily fit this definition.⁶⁷ Other semigovernmental entities, such as a water authority or an irrigation district, however, may not.⁶⁸ These entities must look to bankruptcy case law to determine whether they fit within the definition.⁶⁹

(b) *The entity must be authorized to be a debtor under Chapter 9 by state law*

As discussed above, to better protect state control over federal intrusion into state commercial affairs, Congress has provided for specific state authorization.⁷⁰ In practice, this means that a state law must exist or be sought specifically granting the municipality, "in its capacity as a municipality or by name," the ability to file for Chapter 9.⁷¹

The specific authorization requirement gives states great leeway as to which, if any, of their municipal entities may seek federal bankruptcy relief. Although twenty-seven states allow their municipalities to file for federal bankruptcy, most of these states set additional requirements or processes for approval as well.⁷² Many states use some form of "gatekeeper" from whom the municipality must receive approval before filing.⁷³ Often, this gatekeeper is a politician or political body. For example, municipalities in Connecticut must obtain the prior written consent of the governor before filing.⁷⁴ Thus, even a state that nominally allows its municipalities to file for bankruptcy may impose additional requirements, some of which may make the path to bankruptcy as much of a political exercise as it is a financial one. The specific state authorization requirement effectively creates dual eligibility processes—one at

⁶⁵ 11 U.S.C. § 921(c) (2012).

⁶⁶ *Id.* § 101(40).

⁶⁷ Francisco Vazquez, *Examining Chapter 9 Municipal Bankruptcy Cases*, in CHAPTER 9 BANKRUPTCY STRATEGIES 173, 183 (Jo Alice Darden ed., 2011) ("A political subdivision generally includes a county, parish, city, town, village, borough, or township.").

⁶⁸ See, e.g., *In re N.Y.C. Off-Track Betting Corp.*, 427 B.R. 256, 265–67 (Bankr. S.D.N.Y. 2010) (noting that legislative history is not helpful in determining the scope of a "political subdivision, public agency, or instrumentality of a State").

⁶⁹ Patrick Darby et al., *Corporate Bankruptcy Panel: Municipal Restructuring*, 29 EMORY BANKR. DEV. J. 333, 335–37 (2013).

⁷⁰ See *supra* notes 46–50 and accompanying text.

⁷¹ 11 U.S.C. § 109(c)(2).

⁷² Anderson, *supra* note 23, at 1152.

⁷³ Henry C. Kevane, *Chapter 9 Municipal Bankruptcy: The New "New Thing"? Part I*, BUS. L. TODAY, May 2011, at 1, 2.

⁷⁴ DABNEY ET AL., *supra* note 50, at 31–35.

the federal level, and one at the state level—making relief complicated for struggling municipalities.

Other states have no authorizing statute.⁷⁵ Although a few of these states affirmatively ban municipalities from filing for bankruptcy, in most states, there is simply nothing on the books to indicate whether filing for bankruptcy is acceptable or not. In these states, municipalities may file for bankruptcy only if they seek explicit permission or changes to state legislation, a process that can be time-consuming and expensive, not to mention fraught with political tension.⁷⁶ In practice then, the specific authorization requirement has made it very difficult for municipalities to obtain Chapter 9 relief.

(c) The entity must be insolvent

Insolvency under the Bankruptcy Code is defined to mean that the municipality is “generally not paying its debts as they become due” or is “unable to pay its debts as they become due.”⁷⁷ In recent years, courts have been receptive to new and creative illustrations of insolvency.⁷⁸ For example, a court may analyze the municipality’s cash flow, budgets, and balance sheets, or its service-delivery abilities, to determine whether the municipality is insolvent.⁷⁹ Municipalities are not required to have raised taxes to the legal limit to be considered insolvent.⁸⁰ To prove insolvency, however, municipalities must often produce “substantial financial and accounting evidence.”⁸¹

(d) The entity must be willing to adjust its debts by implementing a plan

This requirement is usually interpreted to mean that the municipality must show that it is filing for bankruptcy in order to develop a plan of adjustment, rather than

⁷⁵ Kevane, *supra* note 73, at 2.

⁷⁶ Paul R. Glassman, *A Practical Guide to Chapter 9 Municipal Bankruptcy*, in CHAPTER 9 BANKRUPTCY STRATEGIES 203, 210 (Jo Alice Darden ed., 2011); *see also* Bill Rochelle & Sherri Toub, *Suffolk Off-Track Betting Confirms Plan in Second Chapter 9 After Three Years*, 26 BANKR. L. REP. (BNA) 1521, 1536 (2014) (noting that Suffolk Off-Track Betting’s first bankruptcy was dismissed after the judge determined that the county legislature was not authorized under state law to give the municipality permission to file and that a year later, the state legislature passed a bill authorizing the municipality to file for bankruptcy).

⁷⁷ 11 U.S.C. § 101(32)(C)(i)–(ii) (2012).

⁷⁸ Lynn M. Brimer et al., *Measuring Service-Delivery Insolvency in Chapter 9*, AM. BANKR. INST. J., Feb. 2014, at 26, 27 (citing the Stockton bankruptcy, where the court examined “service-delivery insolvency”).

⁷⁹ *Id.* at 26.

⁸⁰ Freyberg, *supra* note 17, at 1005.

⁸¹ Glassman, *supra* note 76, at 211.

to buy time or avoid creditors.⁸² Therefore, courts will look for the municipality to have developed some sort of plan or outline of a plan when it decides to file.⁸³

(e) *The entity must demonstrate some sort of relationship with creditors*

The final eligibility prong requires demonstration of one of four possibilities with respect to this relationship.⁸⁴ The municipal entity must show it:

(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that . . . [will be] impair[ed] under a plan . . . ;

(B) has negotiated in good faith with creditors, and has failed to obtain the [necessary] agreement . . . ;

(C) is unable to negotiate with creditors because such negotiation is impracticable; or

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable [as a preference].⁸⁵

The second and third possibilities are frequently the subject of eligibility battles. Notably, the second possibility only requires the *debtor* to negotiate in good faith; in other words, no reciprocal good-faith requirement exists for creditors.⁸⁶ What it means to negotiate in “good faith” is unsettled under the law, meaning that debtors may manipulate the facts in order to demonstrate that good-faith negotiations have occurred.⁸⁷ The third possibility, often used by larger cities and towns, requires the debtor to negotiate with large groups of creditors.⁸⁸ Detroit is the

⁸² Eric S. Pommer & Marc M. Friedman, *Municipal Bankruptcy and Its Effect on Government Contractors*, 25 PUB. CONT. L.J. 249, 254 (1996).

⁸³ *In re City of Vallejo*, 408 B.R. 280, 297 (B.A.P. 9th Cir. 2009) (noting that the good-faith negotiation requirement means that “some outline or term sheet of a plan which designates classes of creditors and their treatment is necessary”). Although the extent to which a municipality must have already developed a plan varies depending on the case, requiring a municipality to have some sort of plan at all is somewhat of a puzzle, given that one of Chapter 9’s arguable advantages is the breathing space it provides for municipalities to assess their situation and develop a workable plan. Interpreting this requirement to mean that municipalities must have a plan or solid plan idea in place at the outset could diminish the value of this breathing space. See John J. Rapisardi et al., *Chapter 9: A Big Stick, Rarely Used*, in CHAPTER 9 BANKRUPTCY STRATEGIES 153, 157 (Jo Alice Darden ed., 2011) (noting that the Bankruptcy Code requires a municipal debtor to file its plan with its bankruptcy petition, but that the court may also set a later date).

⁸⁴ 11 U.S.C. § 109(c)(5)(A)–(D) (2012).

⁸⁵ *Id.*

⁸⁶ See Darby et al., *supra* note 69, at 343.

⁸⁷ See *In re N.Y.C. Off-Track Betting Corp.*, 427 B.R. 256, 274, 278–79 (Bankr. S.D.N.Y. 2010) (noting that courts disagree over what is required to show that good-faith negotiations have occurred but agree that “no formal complete plan” is necessary).

⁸⁸ *In re City of Detroit*, 504 B.R. 97, 176–79 (Bankr. E.D. Mich. 2013).

most recent and notable municipal entity to have utilized this possibility to meet this eligibility requirement.⁸⁹

The manipulability of the “good faith” and “impracticability” measures has come to Congress’s attention. In 2014, Representative John Conyers introduced legislation to amend §109 to require a municipality to negotiate with creditors before seeking Chapter 9 protection unless such negotiations would be “impossible” rather than impracticable.⁹⁰ The bill also proposed changing the definition of “good faith.”⁹¹

2. Extensive Eligibility Fights

Litigation over whether a municipal debtor has met all of the requirements for Chapter 9 eligibility is common in the bankruptcy cases of towns and cities. This is in part because of the structure of the eligibility requirements. Since a debtor must usually negotiate with creditors prior to filing a case, if a Chapter 9 case is in fact filed, creditors opposed to the debtor’s position are already lined up and ready to fight before the case gets off the ground.⁹² This is in stark contrast to a Chapter 11 case, where there are virtually no eligibility requirements and where the bankruptcy filing may even come as a surprise to some creditors.⁹³

Chapter 9 eligibility battles are difficult for several reasons. As previously mentioned, many of the requirements, such as the necessity of negotiating with creditors in “good faith,” have devolved into opaque and confusing standards, as judges attempt to apply the requirements to a variety of municipal entities, each charged with negotiating with vastly different groups of creditors.⁹⁴

⁸⁹ Joseph Lichterman & Bernie Woodall, *In Largest-Ever U.S. City Bankruptcy, Cuts Coming for Detroit Creditors, Retirees*, REUTERS (Dec. 3, 2013, 5:59 PM), <http://www.reuters.com/article/us-usa-detroit-bankruptcy-judge-idUSBRE9B20PZ20131203> [<https://perma.cc/3UQV-R49G>].

⁹⁰ Stephanie M. Acree, *Conyers Introduces Bills Protecting Workers in Ch. 9 Cases; Preventing Utility Termination*, 26 BANKR. L. REP. (BNA) 985, 989 (2014).

⁹¹ *Id.* Specifically, the bill would require the phrase “good faith” to be interpreted according to the National Labor Relations Act, a stricter standard. Kyle Glazier, *Bill Would Make Chapter 9 Tough to Pursue*, BOND BUYER (Jan. 8, 2015, 1:41 PM) (on file with the Utah Law Review), <http://www.bondbuyer.com/news/washington-budget-finance/bill-would-make-chapter-9-tough-to-pursue-1069372-1.html>. Since being introduced in the House of Representatives in July 2014, the bill has received little attention. *See id.*

⁹² Glassman, *supra* note 76, at 208–09; *see also* Jacoby, *supra* note 64, at 855 (noting that the early days of Detroit’s bankruptcy were characterized by multiple objections from creditors).

⁹³ *See* Bret A. Maidman, *Chapter 13 v. Chapter 11 Bankruptcy for Small Business Owners*, NOLO, <http://www.nolo.com/legal-encyclopedia/chapter-13-chapter-11-bankruptcy-small-business-owners.html> [<http://perma.cc/52DT-LNEW>] (last visited Dec. 2, 2015) (“[A]lmost anyone can file bankruptcy under Chapter 11. . . . There are no debt or income requirements or limitations for filing . . .”).

⁹⁴ *See supra* note 87 and accompanying text.

The position of the court and creditors in a Chapter 9 case provides further insight into why eligibility is such a contentious issue. Once again responding to concerns that Chapter 9 interferes with states' ability to govern their internal commercial affairs, Congress gave the bankruptcy judge a very minor role to play in Chapter 9 cases.⁹⁵ For example, under Chapter 9, bankruptcy courts are prohibited from interfering with a municipality's property and revenue absent the municipality's consent, meaning that a municipality may spend its money in any way that it likes without court oversight.⁹⁶ Practically speaking then, eligibility hearings are one of the few times in a Chapter 9 case where the judge, and the creditors, can have a say in how the case proceeds.⁹⁷ In contrast to Chapter 11, where creditors typically can and do exercise their right to participate in numerous hearings, in Chapter 9, there are generally few bankruptcy court hearings.⁹⁸

Furthermore, unlike in Chapter 11, Chapter 9 does not permit creditors to file a competing plan of adjustment. Instead, the municipality is the only entity that can present a plan of adjustment for its debts, and creditors must simply vote for or against that plan.⁹⁹ Finally, creditors are limited in both the information they can access¹⁰⁰ and the type of relief they can request from the bankruptcy court. For example, creditors may not convert the case to another bankruptcy chapter, nor, in general, may they appoint a trustee or examiner to oversee the municipality's operations and affairs.¹⁰¹ Creditors struggle with these limitations and often feel as though they cannot maximize their recoveries under Chapter 9.¹⁰² Thus, creditors

⁹⁵ Specifically, Sections 903 and 904 of the Bankruptcy Code actively constrain the bankruptcy courts. *See* 11 U.S.C. § 903 (2012) (confirming that the state controls the municipality); *Id.* § 904 (preventing courts from interfering with the debtor's political powers, property, revenues, and uses of certain property).

⁹⁶ Turscak et al., *supra* note 56, at 56.

⁹⁷ Stanley H. McGuffin, *Chapter 9 As a Remedy for Financially Stressed Municipalities*, in CHAPTER 9 BANKRUPTCY STRATEGIES 70–76 (Jo Alice Darden ed., 2011).

⁹⁸ *Id.* at 72–74.

⁹⁹ *Id.* at 76.

¹⁰⁰ Kenneth R. Epstein & Nelly Almeida, *The Need for Greater Transparency in Municipal Bankruptcies*, WEIL BANKR. BLOG (Dec. 18, 2014), <http://business-finance-restructuring.weil.com/chapter-9/the-need-for-greater-transparency-in-municipal-bankruptcies/> [<http://perma.cc/QRB6-QYP9>] (arguing that a lack of mandatory disclosure requirements for Chapter 9 debtors has resulted “in burdensome discovery . . . which increases creditor and debtor litigation costs and diminishes the pool of assets available to pay claims”).

¹⁰¹ McGuffin, *supra* note 97, at 76.

¹⁰² Lance Duroi, *Unhappy Creditors Open Assault on Detroit Ch. 9 Plan*, LAW 360 (Sept. 3, 2014, 7:33 PM), <http://www.law360.com/articles/573429/unhappy-creditors-open-assault-on-detroit-ch-9-plan> [<https://perma.cc/23XL-EAZR>] (describing the concerns Detroit's bond insurers expressed over the city's decision to pay its retirees more than its financial creditors); *see also* Karol K. Denniston, *Neutral Evaluation in Chapter 9 Bankruptcies: Mitigating Municipal Distress*, 32 CAL. BANKR. J. 261, 263 (2012) (“The administrative costs and the length of a Chapter 9 proceeding have the potential to seriously impair what is likely to be an already impaired group of creditors.”).

will fight a municipality's entry into bankruptcy court tooth and nail.¹⁰³ The truncated powers of creditors, sometimes touted as one of Chapter 9's chief benefits,¹⁰⁴ help explain why creditors may seize on the eligibility hearing as a chance to assert what little influence they have in a Chapter 9 case.¹⁰⁵

Once a municipal debtor passes through the eligibility gate, courts have held that federal bankruptcy law (not state law) governs the issues that arise within the case. Thus, the generally accepted rule is that states that authorize municipalities to use Chapter 9 must accept Chapter 9 in its totality.¹⁰⁶ For this reason, even a state with a statute that authorizes Chapter 9 relief will sometimes object to a municipality's eligibility to file over concerns that federal bankruptcy law will interfere with the state's wishes for the municipality. For example, Pennsylvania initially authorized Chapter 9 relief for cities like Harrisburg, but when Harrisburg actually sought to file for bankruptcy, the state passed a new law blocking access to federal relief and objected strenuously to Harrisburg's attempts to file for Chapter 9.¹⁰⁷

Although the stakes are high in an eligibility battle, denial of eligibility for bankruptcy protection does not necessarily spell the end of a municipality's existence. In some instances, the judge might dismiss the case because the debtor has regained its financial footing, in which case the municipality may be able to continue to function on its own.¹⁰⁸ In other cases, however, the municipality is left to its own devices. For example, after its second petition for bankruptcy relief was denied, the village of Washington Park, Illinois continued to struggle with its debts and eventually was forced to consider disbanding its police force, a move that, though likely financially necessary, was hardly wise in light of the village's other

¹⁰³ Denniston, *supra* note 102, at 268 (“Whether a municipality has negotiated in good faith with its creditors before filing a petition is almost always litigated in a Chapter 9 case.”).

¹⁰⁴ Lauren M. Wolfe, *The Next Financial Hurricane? Rethinking Municipal Bankruptcy in Louisiana*, 72 LA. L. REV. 555, 566 (2012) (describing “cram down” and creditors’ weaker bargaining position as benefits of Chapter 9).

¹⁰⁵ See *In re City of Desert Hot Springs*, 327 F.3d 930, 935 (9th Cir. 2003) (“Congress, in an effort to avoid possible constitutional problems, designed [C]hapter 9 of the bankruptcy code in a manner much different from the other chapters. Many of the protections afforded to creditors in the other chapters are missing in [C]hapter 9.”).

¹⁰⁶ Trotter, *supra* note 15, at 76.

¹⁰⁷ See South & Egan, *supra* note 49.

¹⁰⁸ See, e.g., RICHARD LEVIN ET AL., CRAVATH, SWAINE, & MOORE LLP, SOME CAUSES OF MUNICIPAL DISTRESS AND BANKRUPTCY (2011), https://www.nabl.org/portals/0/documents/panel_21_-_levin_material.pdf [<https://perma.cc/JDR7-UKMJ>] (noting that the Chapter 9 bankruptcy filing by the City of Gould, Arkansas was dismissed after the municipality regained financial stability); Rick Benedict, *Illinois Village Seeks Bankruptcy Protection*, DAILYREPORTER.COM (Aug. 4, 2009, 12:41 PM), <http://dailyreporter.com/2009/08/04/illinois-village-seeks-bankruptcy-protection/> [<http://perma.cc/2K29-773F>] (describing Washington Park’s first bankruptcy, which “was dismissed because the village [briefly] emerged from insolvency”).

troubles, including the murder of its mayor.¹⁰⁹ In other cases, municipalities that are denied federal relief may seek out remedies under state law. For example, after being denied bankruptcy relief, Harrisburg entered Pennsylvania's state insolvency system.¹¹⁰ In other scenarios, the municipality's creditors may seek a writ of mandamus in state court to compel the municipality to raise taxes.¹¹¹ Nevertheless, the potential loss of essential services after being denied Chapter 9 eligibility means that municipalities that have decided to file will often fight strenuously to have their case deemed eligible for bankruptcy relief. Unfortunately, the drain on time, resources, and money to fight this eligibility battle is substantial.

3. *The Harms of Eligibility Battles*

An eligibility fight can easily take on a life of its own in a municipal bankruptcy case. This is true even where it is ultimately determined that the municipality is ineligible for relief. For example, at the time of Washington Park's bankruptcy, Illinois had not enabled the municipality to declare bankruptcy.¹¹² In fact, legal precedent existed showing that municipalities such as Washington Park were not unconditionally authorized to file for Chapter 9 in Illinois.¹¹³ Nevertheless, it took over a year for the bankruptcy judge to throw out Washington Park's case, leaving the town in limbo during that time.¹¹⁴

It is often difficult for the municipality to amass the evidence necessary to prove that it meets the eligibility requirements. This is particularly true in the case of insolvency. Some cities and towns may seek Chapter 9 relief only after a new administration enters office and learns that the previous administration has created a financial disaster. The new administration is forced to rely on scant or inaccurate record-keeping by the previous administration in order to make its case for

¹⁰⁹ Tim Jones, *Illinois Stripper Haven Shows States Miss Bankruptcy Mess*, BLOOMBERG BUS. (July 23, 2013, 6:00 PM), <http://www.bloomberg.com/news/2013-07-24/illinois-stripper-haven-shows-states-miss-bankruptcy-mess.html> [<http://perma.cc/L33K-T4Y3>] (noting that all but one member of the village's fire department had been laid off and that the police chief had urged city leaders to shut down the department).

¹¹⁰ See *Act 47 Financial Distress*, PA. DEP'T COMMUNITY & ECON. DEV., <http://www.newpa.com/local-government/services-we-provide-local-governments/request-assistance/list-act-47-distress-determinations> [<http://perma.cc/37CP-Z4K3>] (last visited Dec. 2, 2015) (listing distress determinations).

¹¹¹ Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1042 (1997).

¹¹² *Five Cities That Were Denied Chapter 9 Protection in the Past*, MICH. RADIO (July 25, 2013), <http://michiganradio.org/post/five-cities-were-denied-chapter-9-protection-past> [<http://perma.cc/NU8Y-LKUV>].

¹¹³ *In re Slocum Lake Drainage Dist. of Lake Cty.*, 336 B.R. 387, 391 (Bankr. N.D. Ill. 2006) ("Independent research by the Court has not revealed any Illinois statute containing the specific authorization required by § 109(c)(2).").

¹¹⁴ Jim Suhr, *Judge Throws Out Ill. Village's Bankruptcy Case*, ASSOCIATED PRESS (Jan. 10, 2011, 2:03 PM), <http://news.yahoo.com/judge-throws-ill-villages-bankruptcy-case-20110110-110319-519.html> [<http://perma.cc/7HRP-KLAL>].

eligibility. For example, the city of Millport, Alabama filed for bankruptcy after the newly elected mayor discovered that the town was almost \$3.5 million behind in payments.¹¹⁵ The former administration neither budgeted nor properly accounted for the town's revenues and expenditures, making it difficult for the new administration to document the city's insolvency.¹¹⁶ Similarly, after the longtime mayor of Moffett, Oklahoma died, the town learned that he had incurred large debts on the town's behalf without the knowledge or consent of its citizens.¹¹⁷ When financial distress comes as a shock to citizens and officials, it can be difficult to gather the evidence to definitively prove insolvency.¹¹⁸

As eligibility, rather than debt relief, becomes the focus, municipalities pour time and resources that could otherwise be directed toward putting together a plan of adjustment into the eligibility proceeding. The fiscal problems fade into the background, as litigation takes up more and more of officials' time. Several examples illustrate this point.

The city of Vallejo, California spent three and a half months locked in an eligibility battle, where resources were diverted from the debtor's ultimate goal of developing a plan and emerging from bankruptcy.¹¹⁹ The evidentiary hearing alone went on for eight days, as the nondebtor parties pursued the litigation as a way to gain leverage in their negotiations with the debtor.¹²⁰ Although the eligibility issue was ultimately decided in Vallejo's favor, creditors promptly appealed, prolonging the battle. The Ninth Circuit Bankruptcy Appellate Panel affirmed Vallejo's eligibility over a year after Vallejo had initially filed its Chapter 9 petition.¹²¹ Although a multibillion-dollar company may well be able to handle the expense and effort needed to engage in such protracted fights by cutting costs in other areas, a city like Vallejo that is already struggling to provide basic public services cannot cut services further in order to fight such a battle and may put itself further into debt in order to keep the lights on while it establishes eligibility for Chapter 9 relief.

¹¹⁵ Keren H. Deal, *An Examination of Municipal Finance Reform Regarding Municipal Bankruptcies in the United States* 165–66 (Aug. 4, 2007) (unpublished Ph.D. dissertation, Auburn University), https://etd.auburn.edu/bitstream/handle/10415/956/DEAL_KEREN_35.pdf?sequence=1 [<https://perma.cc/UQD7-D7KQ>].

¹¹⁶ *Id.*

¹¹⁷ Tony Thornton & Sheila Stogsdill, *Moffett Seeks Bankruptcy Protection: Town Bears Toll of Designation as a Speed Trap and Debts Incurred by the Late Mayor*, NEWSOK (Feb. 2, 2007), <http://newsok.com/moffett-seeks-bankruptcy-protectionbrspan-classl12town-bears-toll-of-designation-as-a-speed-trap-and-debts-incurred-by-the-late-mayor.span/article/3007448> [<http://perma.cc/MX2D-XNSF>].

¹¹⁸ Even cities that have not experienced a significant change in administration may find it difficult to assemble complete and accurate financial information. In Stockton, California's eligibility dispute, for example, creditors argued that Stockton was relying on outdated financial data. *See Preliminary Objection of Assured Guaranty Corp. and Assured Guaranty Municipal Corp. to Debtor's Chapter 9 Petition and Statement of Qualifications* at 10–11, No. 12-32118 (Bankr. E.D. Cal. Aug. 9, 2012).

¹¹⁹ Glassman, *supra* note 76, at 215.

¹²⁰ *Id.*

¹²¹ *In re City of Vallejo*, 408 B.R. 280, 285 (B.A.P. 9th Cir. 2009).

Also in California, Stockton and San Bernardino have followed in Vallejo's footsteps. It took almost a year for the bankruptcy court to decide that the city of Stockton was eligible to be a Chapter 9 debtor.¹²² During this time, Stockton spent an enormous amount of time and money just trying to stay in bankruptcy while its infrastructure took a severe hit. Homicide rates jumped as police officers left the city in droves.¹²³ The city cut its workforce by 30% and its budget by \$90 million.¹²⁴ Far from expressing concern over these alarming public health and safety conditions, the creditors opposed to the city's eligibility pressed on, using what Stockton's city manager called a "scorched-earth" strategy designed to make the city waste additional time and money.¹²⁵ By the time Stockton's eligibility was finally decided, the city had spent over \$6 million on mediation and legal costs related to the eligibility fight alone.¹²⁶ This number represented approximately half of the money Stockton had budgeted for its entire bankruptcy that year.¹²⁷

Stockton's eligibility battle illustrates that creditors' incentives are generally not aligned with the public health and safety concerns of a municipality. This is a key contrast from a business bankruptcy, where creditors, shareholders, and the debtor often see keeping the business going as a way to maximize value for all parties involved.¹²⁸

The city of San Bernardino, California took a year to get through its eligibility fight.¹²⁹ Even after it was deemed eligible for Chapter 9 relief, one creditor, the California Public Employees' Retirement System ("CalPERS"), appealed the eligibility decision, forcing the city to pay even more money fighting for eligibility, when the real issue CalPERS cared about (nonpayment) was not at stake in the

¹²² *In re City of Stockton*, 493 B.R. 772, 776–77 (Bankr. E.D. Cal. 2013).

¹²³ Cambi Brown, *Stockton's Homicide Rate Sees Drastic Drop Following Record-Breaking Year*, CBS SACRAMENTO (Dec. 29, 2013, 11:12 PM), <http://sacramento.cbslocal.com/2013/12/29/stocktons-homicide-rate-sees-dramatic-drop-following-record-breaking-year/> [<http://perma.cc/N6YP-52JZ>] (noting that in 2012, "amidst the city's money trouble and bankruptcy, violence erupted" and that a "record-setting 71 people were murdered").

¹²⁴ Robin Respaut, *Trial Starts Monday to Determine If Stockton Can Exit Bankruptcy*, REUTERS (May 11, 2014, 7:00 AM), <http://www.reuters.com/article/2014/05/11/municipals-stockton-preview-idUSL2N0NV1BO20140511> [<http://perma.cc/CC85-4A64>].

¹²⁵ Jonathan Weber, *Court Says City of Stockton, California May Proceed with Bankruptcy*, REUTERS (Apr. 1, 2013, 9:44 PM), <http://www.reuters.com/article/2013/04/02/us-stockton-bankruptcy-idUSBRE9300GP20130402> [<https://perma.cc/DX75-JW4Y>].

¹²⁶ *Id.*

¹²⁷ CITY OF STOCKTON, ANNUAL BUDGET 2013–2014, at A-14, http://www.stocktongov.com/files/13-14_Adopted_Budget_.pdf [<http://perma.cc/TW8E-YAFU>] (showing adopted budget for fiscal year 2013–2014 as approximately \$12.5 million).

¹²⁸ See Moberg & Wagner, *supra* note 55, at 32 ("In commercial corporations, the interests of shareholders and managers are not in conflict with one another because they share a common interest in efficient corporate operation.")

¹²⁹ Liz Farmer, *San Bernardino Becomes 3rd California City to Get Bankruptcy Protection*, GOVERNING (Aug. 29, 2013), <http://www.governing.com/blogs/view/gov-judge-awards-san-bernardino-bankruptcy-protection.html> [<http://perma.cc/H8Q4-XF42>].

eligibility hearing.¹³⁰ San Bernardino's eligibility battle is an example of how creditors use eligibility as a proxy for another issue that they will have more difficulty fighting once the debtor enters bankruptcy due to the limited powers of the court and creditors in a Chapter 9 case.

Eligibility also sometimes requires courts to examine complex state law. The question of eligibility for two Alabama municipalities, Jefferson County and Prichard, was ultimately determined to require interpretation of an arcane state statute.¹³¹ Thus, the bankruptcy cases were stayed while the question proceeded to the Alabama Supreme Court.¹³² Prichard finally received permission to proceed two and a half years after it had initially sought bankruptcy relief.¹³³ During the interim period, Prichard ceased paying pensions to its retirees.¹³⁴

Finally, the city of Detroit spent nearly \$23 million in fees to lawyers, consultants, and financial advisers in the first three months of its bankruptcy alone.¹³⁵ A substantial amount of this money was spent in pursuit of an eligibility determination.¹³⁶ That determination took over four months, and seven different entities appealed the determination, prolonging an already expensive and time-consuming process.¹³⁷

Clearly, eligibility battles can take a significant amount of time and divert resources from both the debtor and creditors. All parties must hire attorneys and devote time to briefing and litigating the eligibility elements. Further, although legal fees must be disclosed in a Chapter 9 case, municipalities are not subject to bankruptcy court approval of professional fee payments.¹³⁸ This means that

¹³⁰ C. Scott Pryor, *Heads I Win, Tails You Lose. Or Is It the Other Way Around?* PRYOR THOUGHTS (Nov. 20, 2013), <http://pryorthoughts.blogspot.com/2013/11/heads-i-win-tails-you-lose-or-is-it.html> [<http://perma.cc/UNV5-9H33>].

¹³¹ See Darby et al., *supra* note 69, at 337–38 (citing the Jefferson County case, where eligibility for bankruptcy was decided by the Alabama Supreme Court based on interpretation of an old state statute).

¹³² *Id.*

¹³³ Will Hueske, *Chapter 9 Update: Alabama Municipalities Eligible As “Debtors” Under Section 109(c)*, WEIL BANKR. BLOG (May 22, 2012), <http://business-finance-restructuring.weil.com/chapter-9/chapter-9-update-alabama-municipalities-eligible-as-debtors-under-section-109c/> [<http://perma.cc/Q999-E236>].

¹³⁴ Cate Long, *The Real History of Public Pensions in Bankruptcy*, REUTERS: MUNILAND (Aug. 8, 2013), <http://blogs.reuters.com/muniland/2013/08/08/the-real-history-of-public-pensions-in-bankruptcy/> [<http://perma.cc/QB4L-F2L9>].

¹³⁵ Joseph Lichterman, *Detroit Has Paid \$23 Million to Consultants Through October 1*, REUTERS (Nov. 20, 2013, 7:29 PM), <http://www.reuters.com/article/2013/11/21/us-usa-detroit-fees-idUSBRE9AK01S20131121> [<http://perma.cc/H5W9-HMGS>].

¹³⁶ *See id.*

¹³⁷ *Federal Court Asked to Suspend Detroit Bankruptcy Appeals*, REUTERS (July 31, 2014, 7:42 PM), <http://www.reuters.com/article/2014/07/31/usa-detroit-bankruptcy-appeals-idUSL2N0Q63DH20140731> [<http://perma.cc/8SDG-SHEM>].

¹³⁸ JONES DAY, *supra* note 9, at 9. This is distinct from the Chapter 11 context, where debtors are prohibited from retaining or paying professionals without bankruptcy court approval. *Id.*

municipalities could be unrestrained in terms of the fees they can run up in an eligibility proceeding, and eligibility, of course, can take a substantial bite out of a municipal entity's operating budget.

The holdout creditor that Chapter 9 was designed to thwart is also usually the individual creditor most directly affected by the impending Chapter 9 case and the creditor most likely to spearhead the eligibility litigation.¹³⁹ In contrast to Chapter 11, where access to bankruptcy court is straightforward, municipalities rarely have unimpeded access to bankruptcy relief.¹⁴⁰ Prolonged eligibility battles can hurt the holdout creditor as well as the debtor, as the money that the debtor spends in an eligibility fight is money that would otherwise be available to pay creditors or bolster public services.

The justification for the stringent eligibility requirements lies in the Bankruptcy Code drafters' concern with ensuring that states maintained control over their municipalities' commercial affairs.¹⁴¹ The requirements reflect the drafters' intention to give municipalities access to federal debt relief only if states approve.¹⁴² Although these concerns are important, in practice, the dual state and federal approval systems create high barriers, which may ultimately harm the municipal entities Chapter 9 was intended to help.

The very design of Chapter 9 encourages holdout creditors to stand their ground and makes it difficult for entities in severe distress to access relief. The incentives created by the eligibility requirements lead to exactly the opposite result of what Chapter 9 was designed to achieve: the holdout creditor remains in play, and debtors run up costs rather than reduce them. Given these harms, it is rightfully puzzling that municipalities nevertheless continue to seek entry into Chapter 9. Although Chapter 9 may not be municipalities' preferred option, it is worth exploring whether the benefits are worth the struggle.

III. CHAPTER 9'S LIMITATIONS

As seen with eligibility hearings, elements of Chapter 9's structure make it difficult to utilize successfully in practice. Section II.A explores why corporate bankruptcy is a poor model for municipal bankruptcy due to key structural and theoretical differences between municipalities and corporations. Using recent municipal bankruptcy cases, section II.B also illustrates that use of Chapter 9 often results in outcomes that are inconsistent with foundational bankruptcy principles. By demonstrating how Chapter 11 is an ill-fitting model for Chapter 9 and how

¹³⁹ See Kevane, *supra* note 73, at 3.

¹⁴⁰ See Steven Lessard & Richard Ngo, *Riding the Juice Train to Bankruptcy: Chapter 9 Eligibility After In re Las Vegas Monorail Company*, 20 NORTON J. BANKR. L. & PRAC. 387, 392–93 (2011).

¹⁴¹ Mary L. Young, *Keeping a Municipal Foot in the Chapter 9 Door: Eligibility Requirements for Municipal Bankruptcies*, 23 CAL. BANKR. J. 309, 314 (1997).

¹⁴² See Nicholas B. Bangos, *Chapter 9 of the Bankruptcy Code: The Dark Side of the Moon*, 3 WESTLAW J. BANKR. 1, 6 (2011), 8 NO. 3 WJBKR 1.

Chapter 9 in practice diverges from optimal bankruptcy outcomes, this Part paves the way for a call to reform the municipal bankruptcy system.

A. Key Differences Between Chapter 9 and Chapter 11

Once a municipality clears the eligibility hurdle, Chapter 9 is supposed to provide municipalities with more power than a corporate debtor has in Chapter 11.¹⁴³ This significant power is yet another reason the barriers to entry for Chapter 9 are so high: it is thought that municipalities should not be able to wield this power easily.¹⁴⁴ On paper, a municipality's powers do indeed seem substantial; in practice, however, these powers are often not as significant as they seem. Municipalities under political pressure, for example, may be hesitant to exercise their bankruptcy powers to reform contracts or impair pensions.

The stark structural differences between a corporate entity and a municipality indicate that Chapter 11 rules are ill-suited to resolve municipal financial problems. For example, unlike a business, a city or town cannot be liquidated or sold to another entity.¹⁴⁵ Furthermore, the composition of claims holders in a municipal bankruptcy looks very different from that of a business bankruptcy, making it difficult to figure out how concepts that are well developed in Chapter 11 apply to Chapter 9.¹⁴⁶ Rules that work well in Chapter 11, such as those relating to debt adjustment, contract assumption and rejection, financing, and plan confirmation, fail to reach the same outcomes in Chapter 9.

1. Debt Adjustments

Debt adjustment is the central function of Chapter 9, yet the extent of debt that can be adjusted is not always clear.¹⁴⁷ For example, nonconsensual modification of

¹⁴³ See, e.g., Kimhi, *supra* note 16, at 356. “[O]nce the bankruptcy filing is approved, the municipality has greater powers than a regular corporate debtor does.” *Id.* These powers include an exclusive right to submit a plan of debt adjustment, the ability of local leaders to continue to manage the municipality, and the bankruptcy court’s inability to interfere with the municipality’s political powers. *Id.* at 356–57.

¹⁴⁴ Kordana, *supra* note 111, at 1043 (“The favorable bargaining position granted to a municipal debtor might suggest that its ability to enter Chapter 9 would need to be restricted.”).

¹⁴⁵ For this reason, some scholars have argued that a more apt model for Chapter 9 is individual bankruptcy rather than corporate bankruptcy. See, e.g., Skeel, *supra* note 41, at 2227–28.

¹⁴⁶ See, e.g., Richard L. Epling et al., *Monorail, Monorail, Monorail: Chapter 9 and Restructuring Issues Relating to Municipal Authorities*, 20 NORTON J. BANKR. L. & PRAC. 225, 235 (2011) (“In Chapter 9, the application of the traditional ‘fair and equitable’ or ‘cram down’ power is unclear.”); Kordana, *supra* note 111, at 1057 (“It is, admittedly, difficult to apply the absolute priority rule to a bankrupt municipality.”).

¹⁴⁷ See David S. Kupetz, *Municipal Debt Adjustment Under the Bankruptcy Code*, 27 URB. LAW. 531, 531–32 (1995) (noting the similarity of general policy considerations underlying municipal debt adjustment and Chapter 11 reorganization but stating that

pensions is a hotly contested issue in Chapter 9.¹⁴⁸ Some states have constitutional provisions prohibiting municipalities from modifying or impairing accrued pension benefits, raising the question of whether bankruptcy law can trump these provisions.¹⁴⁹ In other circumstances, municipal debtors sometimes *favor* pension claims over other debt, raising questions about whether this is permissible under bankruptcy priority rules.¹⁵⁰ Pension obligations typically make up a significant portion of a struggling municipality's liabilities, making resolution of these issues critical for an effective debt adjustment.¹⁵¹ The extent to which a municipality's need to protect city employees and encourage them to work for the municipality must be reconciled with the municipality's ability to rid itself of burdensome debt obligations remains unresolved. This lack of clarity undermines predictability in the law, leaving municipalities uncertain as to whether and how they may adjust pensions in bankruptcy, and spurring on costly litigation in an attempt to resolve the matter.¹⁵²

In contrast to Chapter 11, where most pre-petition debt is dischargeable, in Chapter 9, municipalities may face limitations on the types of debt they can adjust.¹⁵³ For example, special revenue bonds and leases are not eligible for adjustment in Chapter 9.¹⁵⁴ This means that in a bankruptcy like Detroit's, where special revenue debt made up over 30% of the city's liabilities, the municipality will not be able to

municipal bankruptcy is "quite unlike" other bankruptcies and acknowledging that "application of the term 'bankruptcy' to Chapter 9 is a misnomer").

¹⁴⁸ See generally Richard M. Hynes & Steven D. Walt, *Fair and Unfair Discrimination in Municipal Bankruptcy* (Univ. of Va. Sch. of Law Pub. Law & Legal Theory Research Paper Series, Paper No. 2014-56), <http://ssrn.com/abstract=2493529> [<http://perma.cc/J334-YABW>] (describing trend of municipalities offering more generous recovery on pension claims than on other claims and arguing that bankruptcy's unfair discrimination standard prevents this outcome if disfavored creditors object).

¹⁴⁹ See Chung, *supra* note 58, at 717–18. Some courts have answered this question in the affirmative. See Lichterman & Woodall, *supra* note 89 (noting that the Michigan Attorney General "argued that pension rights are protected by the state constitution," but the judge in the Detroit case cut pensions anyway).

¹⁵⁰ Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609, 612 (2014) (summarizing the confusion over payment priority between retirees and bondholders).

¹⁵¹ A recent study concluded that there was a \$1 trillion gap between the amount actually set aside by states and localities to pay pensions and other benefits, and the estimated actual cost of those obligations. See Chung, *supra* note 58, at 669 (discussing the study and its implications).

¹⁵² See, e.g., Dale Kasler, *Creditors Launch Challenge to CalPERS, Pensions in San Bernardino Bankruptcy*, SACRAMENTO BEE (Jan. 8, 2015, 12:36 PM), <http://www.sacbee.com/news/business/article5638170.html> [<http://perma.cc/2W3C-67QH>].

¹⁵³ See Francisco Vazquez & Eric Daucher, *Restructuring a Municipality Under Chapter 9*, AM. BANKR. INST. J., July/Aug. 2010, at 50, 51–52.

¹⁵⁴ See Henry C. Kevane, *Chapter 9 Municipal Bankruptcy: The New "New Thing"?* Part II, BUS. L. TODAY, June 2011, at 1, 2 (noting that "the legislative history to Chapter 9 clarifies that industrial revenue bonds, issued by municipalities purely as conduits for private entities, are excluded from Chapter 9").

effectuate a complete debt adjustment.¹⁵⁵ Municipalities may be further discouraged from adjusting debts out of concern that impairing debt may limit their access to capital markets and future funding.¹⁵⁶

2. *Contract Assumption and Rejection*

One of the most touted advantages of Chapter 9 is that it gives municipal debtors the ability to renegotiate and reject contracts.¹⁵⁷ Indeed, this is a key advantage of federal bankruptcy relief, which allows debtors to assume or reject executory contracts, including collective bargaining agreements, despite contrary state law provisions.¹⁵⁸ For municipalities, this ability is limited in practice. Unlike in Chapter 11, where the statute clearly provides the standard for rejection or modification of a collective bargaining agreement,¹⁵⁹ uncertainty remains in Chapter 9 as to whether and how a debtor may modify and reject these agreements.¹⁶⁰ This makes it difficult for municipal debtors to modify their agreements easily or quickly.¹⁶¹

3. *Financing*

Another key distinction between municipal bankruptcy and business bankruptcy further complicates the relief available to a municipality. In a business case, the pre-petition and post-petition entities are often considered completely separate. A line is drawn separating the pre-petition entity from the “new company”

¹⁵⁵ Chung, *supra* note 58, at 667–68.

¹⁵⁶ DABNEY ET AL., *supra* note 50, at 37–47.

¹⁵⁷ Chung, *supra* note 14, at 831 (“While bankruptcy law endeavors to provide a system of orderly, predictable rules or treatment of parties whose contracts are impaired, that does not change *the starring role of contract impairment* in bankruptcy.” (emphasis added) (quoting *In re City of Detroit*, 504 B.R. 97, 150 (Bankr. E.D. Mich. 2013))).

¹⁵⁸ See S. REP. NO. 95-989, at 112 (1978) (noting that collective bargaining agreements and other executory contracts “may be rejected despite contrary State laws”).

¹⁵⁹ 11 U.S.C. § 1113 (2012).

¹⁶⁰ Trotter, *supra* note 15, at 81 (noting that the case law creates “a cloud of uncertainty over the issues of modification and rejection of collective bargaining agreements in Chapter 9”).

¹⁶¹ Proposed legislation would require employees to consent to changes in contracts, including changes to pension and health-care benefits. William Selway, *House Democrats Seek to Protect Workers in Municipal Bankruptcy*, BLOOMBERG (July 17, 2014), <http://www.bloomberg.com/news/print/2014-07-17/house-democrats-seek-to-protect-workers-in-municipal-bankruptcy.html> [<http://perma.cc/R6CP-5L64>]. Other legislation would make it more difficult for municipal debtors to cut retiree benefits in bankruptcy at all. *Id.* Although this legislation attempts to strike a balance between allowing insolvent municipalities to find relief and protecting promised core contract rights, it may undercut the ability of a Chapter 9 debtor to renegotiate contracts in bankruptcy.

or the “estate” once a company files for bankruptcy.¹⁶² This line drawing is often reinforced by changes in management or even a sale of the company’s assets to a new entity. In municipal bankruptcies, however, the line between the pre-petition municipality and the post-petition entity is decidedly blurred. Although it has filed for bankruptcy, the municipality lacks an “estate,” or a body of assets that creditors can look to for recovery, in part because it lacks the ability to liquidate.¹⁶³ Similarly, the bankruptcy court lacks the ability to force the municipality to sell any property for the benefit of creditors.¹⁶⁴ In essence, no equivalent “new municipality” is forged from the bankruptcy. Because the municipality can never completely separate itself from its pre-bankruptcy “self,” as a business can, it may have a much more difficult time emerging from bankruptcy as a financially and operationally sound entity.

This problem is evident when it comes to bankruptcy financing. Typically, when a business files for bankruptcy, it may take advantage of Bankruptcy Code provisions and obtain new funding to finance the costs of the case.¹⁶⁵ Although the same Code provisions apply in a Chapter 9 case, the court’s powers to order a municipal debtor to comply with a lender’s typically exacting requirements are extraordinarily limited.¹⁶⁶ Thus, municipal entities typically do not receive post-petition financing in bankruptcy.¹⁶⁷ Even once a municipality has come up with a plan of adjustment, it may be on its own when it comes to finding the money to pay creditors under that plan. The municipality may of course look to taxpayers to raise revenue, but the ability to obtain financing from an outside lender could mitigate the need to raise taxes, encouraging residents to remain in the municipality rather than leave for a city or town with a lower tax rate.

4. Political Constraints

Municipalities are inherently political entities¹⁶⁸ and may be influenced to a greater degree than businesses by the state and local politics that surround them. Many scholars have acknowledged Chapter 9’s inability to address certain political problems, such as difficulties with mobilizing constituencies in support of debt

¹⁶² For example, the reorganized, post-bankruptcy General Motors is consistently referred to as the “new GM” to distinguish it from the pre-bankruptcy “old GM.” See, e.g., General Motors Co., Annual Report (Form 10-K), at 1 (2010).

¹⁶³ Vincent S.J. Buccola, Law and Legislation in Municipal Bankruptcy 16 (Mar. 3, 2016) (unpublished manuscript) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2534856 [<https://perma.cc/3ZVJ-KG3S>] (noting that a creditor cannot respond to municipal default by seizing city assets).

¹⁶⁴ *Id.* at 21.

¹⁶⁵ 11 U.S.C. § 364 (2012).

¹⁶⁶ See Manny Grillo, *DIP Loans: A New Pocketbook for Distressed Municipalities?*, MUNIBK BLOG (Sept. 24, 2012), <http://blog.munibk.com/dip-loans-a-new-pocketbook-for-distressed-municipalities> [<http://perma.cc/2VX3-V24H>].

¹⁶⁷ *Id.*

¹⁶⁸ See 11 U.S.C. § 101(40) (defining a municipality as “a political subdivision . . . of a state”).

adjustment or local officials' vulnerability to political influence.¹⁶⁹ Although no form of bankruptcy is intended to address political problems head-on, in a municipal bankruptcy, political problems are intertwined with the municipality's financial distress to a greater degree than in a corporate or personal bankruptcy.¹⁷⁰ For business bankruptcy, management's ability to implement top-down policies is often significant.¹⁷¹ In contrast, officials running a municipality are often subject to extreme pressure from voters and interest groups.¹⁷² In some cases then, the solution to a municipality's fiscal problems may lie, not in a debt adjustment, but in addressing the political incentives that drove the municipality to seek bankruptcy relief in the first place.

Political problems may take the form of legal constraints on raising taxes or seeking new funding sources, thus preventing the municipality from taking steps to get its budget under control. For example, in California, Proposition 13 places a cap on property taxes, and Proposition 218 requires municipalities to attain the vote of property owners for any proposed new or increased assessments.¹⁷³ The California Constitution also contains prohibitions on the amounts of debt a city can incur.¹⁷⁴ If municipalities cannot easily raise new funds without resorting to the political process, they will have a more difficult time emerging from bankruptcy successfully.

In general, taxpayers and residents of a municipality are not considered parties in interest in a Chapter 9 case and therefore do not have a say in the bankruptcy's progress, aside from the officials they elect to represent them in the governance of the municipality.¹⁷⁵ Yet, because a municipality must receive regulatory and electoral approval in order to carry out a plan, the debtor will likely have to deal with the same political forces and community dynamics it faced outside of bankruptcy while it is in bankruptcy.¹⁷⁶ Chapter 9 cannot provide the municipality with the tools

¹⁶⁹ See, e.g., Gelpert, *supra* note 17, at 895 (“Bankruptcy is at best unproven, and at worst unsuited to overtly political tasks, such as mediating among political interest groups and brokering fiscal federalism.”); Juliet M. Moringiello, *Specific Authorization to File Under Chapter 9: Lessons from Harrisburg*, 32 CAL. BANKR. J. 237, 238 (2012); Elizabeth M. Watkins, Note, *In Defense of the Chapter 9 Option: Exploring the Promise of a Municipal Bankruptcy As a Mechanism for Structural Political Reform*, 39 J. LEGIS. 89, 97 (2013) (“The perfect storm for municipal default includes both internal (political) and external factors (socioeconomic)—some controllable and some not.”).

¹⁷⁰ See Moberg & Wagner, *supra* note 55, at 41 (“[T]he accumulation of [municipal] debt is more a political than a technical problem.”); Richard C. Schragger, *Democracy and Debt*, 121 YALE L.J. 860, 864 (2012) (noting that “the solution to state and local fiscal crises is largely a matter of politics and not a matter of institutional design”).

¹⁷¹ See RICHARD I. AARON, BANKRUPTCY LAW FUNDAMENTALS § 4:5 (2014).

¹⁷² See *supra* note 170 and accompanying text.

¹⁷³ See Chung, *supra* note 58, at 679–81.

¹⁷⁴ *Id.* at 681.

¹⁷⁵ Nevertheless, a “special tax payer” may object to confirmation of a Chapter 9 plan. 11 U.S.C. § 943(a) (2012). A “special tax payer” is defined in the Bankruptcy Code and relates to someone who owns real property against which special assessments or special taxes have been levied. *Id.* § 902(3).

¹⁷⁶ Kevane, *supra* note 154, at 1.

necessary to face these forces; however, without the ability to address political problems, a municipality will not succeed in Chapter 9 anyway.

A separate concern is that Chapter 9 may artificially shield debtors from their political problems. For example, observers of Stockton, California's bankruptcy case have argued that bankruptcy simply allows the city to make a debt adjustment without requiring it to fix the real problems that led to its insolvency in the first place, such as bad fiscal policies and unsustainable pension systems.¹⁷⁷ A California think tank that assessed the aftermath of the Orange County, California bankruptcy in the 1990s also concluded that the main issue causing Orange County's failure was not a financial issue but a failure of governance.¹⁷⁸ Thus, Chapter 9 cannot, by itself, resolve underlying political issues and may in fact enable a municipality to hide behind financial problems rather than address the political issues that have led it to seek bankruptcy protection in the first place.

In order for a successful debt adjustment to occur, a municipality must often confront the political forces surrounding it. This means that bankruptcy is going to be an incomplete solution in the municipal context. Once again, due to key differences between a municipality and a business, bankruptcy mechanisms that may provide a more complete solution in Chapter 11 are at best only a partial solution in Chapter 9.

5. *The Holdout Creditor*

A key benefit of bankruptcy is the ability to force parties to the bargaining table and, if negotiations fail, to overcome holdout creditors by "cramming down" a plan over their objections.¹⁷⁹ By allowing the bankruptcy judge to approve a plan that is feasible and fair, Chapter 9 can inhibit the holdout creditor's desire to get more out of the debtor than what it is actually entitled to.¹⁸⁰ A close look at several recent municipal bankruptcies shows, however, that Chapter 9 may not be effective at getting the holdout creditor under control.

In the Detroit bankruptcy, the fight with holdout creditors Financial Guaranty Insurance Company and Syncora Guarantee Inc. generated high fees that Detroit

¹⁷⁷ Rex Sinquefeld, Opinion, *Stockton, CA: One of America's Most Miserable Cities Just Got More Miserable*, FORBES (Apr. 5, 2013, 8:00 AM), <http://www.forbes.com/sites/rexsinkefeld/2013/04/05/stockton-ca-americas-most-miserable-city-just-got-a-lot-more-miserable/> [<http://perma.cc/97S5-NMB4>]. Indeed, in its plan of adjustment, Stockton left its pensions untouched, likely because pension reform is politically unpopular. See Dale Kasler, *Judge Approves Stockton's Plan to Repay Creditors, Leaving Pensions Intact*, SACRAMENTO BEE (Oct. 30, 2014, 1:03 PM) (on file with the Utah Law Review), <http://www.sacbee.com/news/business/article3474893.html>.

¹⁷⁸ PUB. POLICY INST. OF CAL., WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY 20 (1998), http://www.ppic.org/content/pubs/op/OP_398OP.pdf [<http://perma.cc/4XTF-SRYW>].

¹⁷⁹ Wolfe, *supra* note 104, at 566.

¹⁸⁰ Buccola, *supra* note 18, at 592–93.

officials alleged the city could not pay.¹⁸¹ These creditors consistently fought against Detroit's eligibility for bankruptcy, even going so far as to argue for dismissal of the case.¹⁸² Syncora even appealed a ruling about Detroit's casino revenue all the way to the Sixth Circuit.¹⁸³ The bankruptcy judge finally forced the two holdouts into mediation.¹⁸⁴ Although the parties ultimately reached a deal with Detroit,¹⁸⁵ the deal came at a high cost: Detroit's legal fees and expenses in fighting these creditors rose to \$26 million, while the cost of all professional services reported prior to the confirmation hearing was approximately \$55 million.¹⁸⁶ Detroit's political leaders argued in court that they could not both pay the professional fees associated with their bankruptcy and improve services for residents.¹⁸⁷

Meanwhile in Stockton's bankruptcy, Franklin Resources Inc. emerged as the lone holdout creditor. Franklin objected strenuously to Stockton's plan, which purported to pay it a fraction of its investment.¹⁸⁸ Although Stockton's plan of adjustment was ultimately confirmed, city officials spent \$16 million on costs associated with the bankruptcy.¹⁸⁹ This represented 3% of Stockton's annual operating budget for 2013-14 and well over the \$12.5 million in the fund the city had set aside to pay for its bankruptcy.¹⁹⁰ After Stockton emerged, the city was predicted to owe almost \$48 million in settlements and other obligations.¹⁹¹ Even

¹⁸¹ Karen Pierog & Lisa Lambert, *Price Tag for Detroit's Bankruptcy Law Firm Hits \$26 Million*, REUTERS (Sept. 8, 2014, 5:09 PM), <http://www.reuters.com/article/2014/09/08/usa-detroit-bankruptcy-fees-idUSL1N0R922J20140908> [<http://perma.cc/J2TN-TGT6>].

¹⁸² Lisa Lambert, *Hold-Out Creditor Argues for Dismissal of Detroit Bankruptcy Case*, REUTERS (July 28, 2014, 3:22 PM), <http://www.reuters.com/article/usa-detroit-fgic-idUSL2N0Q31CM20140728> [<http://perma.cc/7MY5-BVUL>].

¹⁸³ Matthew Dolan, *Creditors Win Bid to Challenge Detroit Bankruptcy*, WALL STREET J. (July 3, 2014, 9:39 AM) (on file with the Utah Law Review), <http://www.wsj.com/articles/creditors-win-bid-to-challenge-detroit-bankruptcy-1404352068>.

¹⁸⁴ Karen Pierog, *Detroit, Hold-Out Creditors Must Go to Bankruptcy Mediation—Judge*, REUTERS (Aug. 26, 2014, 1:19 PM), <http://www.reuters.com/article/2014/08/26/usa-detroit-bankruptcysyncoraguarantee-idUSL1N0QW1H320140826> [<http://perma.cc/Q66Y-BAQT>].

¹⁸⁵ Karen Pierog & Lisa Lambert, *Syncora, Detroit Reach Deal in Principle over City Bankruptcy*, REUTERS (Sept. 9, 2014, 9:12 PM), <http://www.reuters.com/article/2014/09/10/usa-detroit-bankruptcy-syncora-guarante-idUSL1N0RA31220140910> [<http://perma.cc/XKF2-4LM3>].

¹⁸⁶ Pierog & Lambert, *supra* note 181.

¹⁸⁷ Melissa B. Jacoby, *What Are the Costs of Detroit's Rise from Bankruptcy?*, CONVERSATION (Nov. 20, 2014, 5:45 AM), <https://theconversation.com/what-are-the-costs-of-detroits-rise-from-bankruptcy-34171> [<http://perma.cc/CD7M-E6EA>].

¹⁸⁸ Roger Phillips, *Stockton Bankruptcy Cost: More Than \$41 Million*, RECORDNET.COM (Oct. 28, 2014, 7:57 PM) (on file with the Utah Law Review), <http://www.recordnet.com/article/20141028/NEWS/141029525> (noting that Franklin had received just over \$4 million from Stockton as repayment for a \$35 million loan).

¹⁸⁹ *Id.*

¹⁹⁰ See CITY OF STOCKTON, *supra* note 127, at A-1, A-7.

¹⁹¹ Phillips, *supra* note 188.

then, Franklin threatened to appeal Stockton's plan of adjustment and further prolong the case.¹⁹²

In San Bernardino, California, holdout unions impeded the city's ability to create a plan of adjustment and even harmed the union members they are supposed to be helping. San Bernardino fought for years with its unions and with CalPERS. These fights slowed progress in the case: the city filed for bankruptcy in August 2012 and had yet to file a plan of adjustment well over two years later.¹⁹³ The slow progress of the talks took a particularly heavy toll on union members, because the unions could not fight pay cuts in the bankruptcy.¹⁹⁴ As a result, some city firefighters began declaring personal bankruptcy.¹⁹⁵ The bankruptcy judge even accused the unions of "stonewalling" negotiations after they attempted to sue the city in state court during the bankruptcy case.¹⁹⁶

Bankruptcy law offers an alternative to these long, drawn-out fights with holdout creditors: confirm a plan of adjustment over the holdout creditor's objection. This so-called "cramdown power" is utilized extensively in Chapter 11 cases, but is practically nonexistent in Chapter 9. In Chapter 9, the plan eventually presented to the court is almost always a consensual one, reached after months or years of negotiations.¹⁹⁷ Thus, Chapter 9 in effect often functions as a drawn-out settlement process. For example, in Detroit, the judicial mediator ordered the city and its major creditors to "keep talking until they come to an agreement."¹⁹⁸ By forcing the city to keep negotiating with creditors in lieu of allowing it to utilize the bankruptcy cramdown tool, the mediator took away one of the key benefits of municipal bankruptcy.

Why is the cramdown option almost never exercised in Chapter 9? The answer may stem from the uncertainty of how to apply the cramdown requirements in a municipal bankruptcy case. For example, a plan that is crammed down may not

¹⁹² Robin Respaut, *Stockton, California, Bankruptcy Judge Denies Motion to Stall Plan*, REUTERS (Jan. 20, 2015, 4:02 PM), <http://www.reuters.com/article/2015/01/20/usa-stockton-idUSL1N0US1MK20150120> [<https://perma.cc/HB5B-TNDW>].

¹⁹³ Tim Reid, *Judge in San Bernardino Bankruptcy Losing Patience with City, Calpers*, REUTERS (May 8, 2014, 6:57 PM), <http://www.reuters.com/article/usa-municipality-sanbernardino-idUSL2N0NU2HY20140508> [<http://perma.cc/DC25-B2E6>].

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ Steven Church, *San Bernardino Judge Accuses Fire Union of 'Stonewalling' Negotiations*, 26 BANKR. L. REP. (BNA) 1025, 1033 (2014).

¹⁹⁷ Although the judge in the City of Stockton's bankruptcy confirmed a plan over the objection of a holdout creditor, the holdout creditor was within a class of creditors that voted to approve the plan, meaning that the usual cramdown requirements for plan confirmation did not apply. See Reporter's Transcript of Proceedings, Findings of Fact and Conclusions of Law at 17–18, *In re City of Stockton*, 493 B.R. 772 (Bankr. E.D. Cal. 2013) (No. 12-32118-C-9).

¹⁹⁸ Karen Pierog & Lisa Lambert, *Detroit End in Sight as Deals Leave FGIC Last Major Bankruptcy Holdout*, REUTERS (Sept. 12, 2014, 6:08 PM), <http://www.reuters.com/article/us-usa-detroit-bankruptcy-idUSKBN0H72IN20140912> [<http://perma.cc/K2K5-GCNQ>].

discriminate unfairly against a class of claims that does not accept the plan.¹⁹⁹ Courts that have applied this standard in Chapter 9 have done so inconsistently, leading scholars to question whether they are complying with the standard.²⁰⁰ Creditors objecting to a plan may also argue that the plan fails to meet the “best interests of creditors” test, which in Chapter 11 requires creditors to receive as much as they would if the debtor’s plan were converted to a Chapter 7 liquidation.²⁰¹ In a Chapter 9 case, where liquidation is not an option, courts struggle with how to decide whether a plan in fact meets the best interests test.²⁰² These uncertainties in plan confirmation standards in turn may make a debtor’s plan susceptible to challenges, even once it is confirmed.²⁰³

In the absence of Chapter 9, the holdout creditor could theoretically never come to the bargaining table at all. Still, when judges hesitate to utilize cramdown, and instead force parties to mediate (or litigate), Chapter 9 becomes more costly and difficult than it needs to be. If the application of Chapter 11-based cramdown rules is too uncertain, perhaps Chapter 9 needs its own set of rules.²⁰⁴

Bankruptcy is typically described as a collective process.²⁰⁵ In Chapter 9, this process becomes a tug-of-war. Highly publicized battles rage between the debtor and one or two holdout creditors. These battles are not mere hypotheticals; in fact, the bankruptcy judge in Detroit explicitly asked the city and one of its holdout

¹⁹⁹ 11 U.S.C. § 1129(b)(1) (2012); *see also* Gary L. Kaplan, *Understanding the Rules of Bankruptcy Cramdown*, LAW360 (Sept. 4, 2013, 3:31 PM), <http://www.law360.com/articles/468678/understanding-the-rules-of-bankruptcy-cramdown> [<http://perma.cc/97N3-L9TS>] (explaining that the rules of bankruptcy cramdown do not allow for unfair discrimination).

²⁰⁰ *See* Hynes & Walt, *supra* note 148, at 19–23 (noting that courts applying the unfair discrimination standard in Chapter 9 have used it to favor retirees over other creditors, potentially contravening bankruptcy law).

²⁰¹ Bret A. Maidman, *Chapter 11 Bankruptcy: An Overview*, NOLO, <http://www.nolo.com/legal-encyclopedia/chapter-11-bankruptcy-overview.html> [<http://perma.cc/3MH5-VN35>] (last visited Dec. 2, 2015).

²⁰² David A. Skeel, Jr., *From Chrysler and General Motors to Detroit*, 24 WIDENER L.J. 121, 142–43 (2015) (noting that the “best interest of the creditors” test is unclear because “liquidation is not an option for a municipal debtor”).

²⁰³ *See, e.g.*, Nathan Bomey, *A Few Retirees Still Fighting Detroit Bankruptcy Plan*, DETROIT FREE PRESS (Jan. 8, 2015, 6:40 PM), <http://www.freep.com/story/news/local/detroit-bankruptcy/2015/01/08/detroit-bankruptcy-retirees-pension-cuts/21445939/> [<http://perma.cc/8KFW-77EP>].

²⁰⁴ *See* Hynes & Walt, *supra* note 148, at 31–32 (arguing that the reason Stockton’s holdout creditor objected so strenuously was related to problems with interpreting the unfair discrimination standard in municipal bankruptcy); Skeel, *supra* note 202, at 144 (“[T]he precise contours of unfair discrimination [in the Chapter 9 context] are unsettled.”).

²⁰⁵ *See, e.g.*, Laura Napoli Coordes, *The Geography of Bankruptcy*, 68 VAND. L. REV. 381, 408 (2015); Skeel, *supra* note 41, at 2233 (“[Bankruptcy] is collective in nature. A bankruptcy framework adjusts the debtor’s relationship with most or all of its creditors . . .”).

creditors to stop using war analogies to describe their disagreements.²⁰⁶ In the meantime, taxpayers and employees are left to suffer as the city's attention and effort become consumed with dragging the holdouts to the bargaining table at any cost in order to eke out a few concessions. Although holdout creditors exist in the Chapter 11 context, the ability of the court to play a more significant role in a Chapter 11 case, and in particular the debtor's well-defined ability to exercise the cramdown power, limit the extent to which holdout creditors can wage war on the Chapter 11 debtor.

Although holdout creditors may eventually settle with municipal debtors, they are central players that inflict substantial harms during the life of a Chapter 9 bankruptcy. Just as they do with eligibility battles, holdout creditors at the plan confirmation stage can wage an all-consuming war on debtors that diverts resources away from debtor rehabilitation. Thus, although Chapter 9 may eventually drive parties to settlement,²⁰⁷ it is not clear that such settlement maximizes value for the debtor, the creditors, or taxpayers. Instead, the very structure of Chapter 9 allows holdout creditors to use the bankruptcy process to dig in their heels until the last possible second, dragging out a painful and expensive case for months or even years. Despite Chapter 9's aim to resolve the holdout creditor problem, a holdout creditor's power in a Chapter 9 case is substantial.

6. *The Aftermath of Chapter 9*

Due to the problems with utilizing Chapter 9, cities and towns emerging from bankruptcy may find themselves financially worse off than they were prior to filing for bankruptcy. In fact, municipalities that have filed for Chapter 9 may return to insolvency within just a few years of filing.²⁰⁸ Although courts are required to determine that a municipality's plan of adjustment is feasible prior to confirming the plan,²⁰⁹ cities that have emerged from bankruptcy often struggle to provide even basic services after their bankruptcy exit, indicating that judicial findings of feasibility may be inaccurate. Multiple examples illustrate this point.

The city of Vallejo, California emerged from Chapter 9 in 2011, but is still mired in pension debt and struggling to provide basic public services, in direct contrast with the core purpose of Chapter 9.²¹⁰ According to Vallejo's city manager,

²⁰⁶ Nathan Bomey, *Detroit Bankruptcy Judge to Consider Sanctions for Syncora Attorneys*, DETROIT FREE PRESS (Aug. 25, 2014, 12:03 AM), <http://www.freep.com/story/news/local/michigan/detroit/2014/08/25/detroit-bankruptcy-judge-to-consider-sanctions-for-syncora-attorneys-/14532517/> [<https://perma.cc/9ZE9-B2GU>].

²⁰⁷ C. Scott Pryor, *Stockton Status*, PRYOR THOUGHTS (Oct. 14, 2013), <http://pryorthoughts.blogspot.com/search?q=stockton+status> [<http://perma.cc/LS9Z-EJ2T>].

²⁰⁸ Kishfy, *supra* note 14, at 362.

²⁰⁹ 11 U.S.C. § 943(b)(7) (2012).

²¹⁰ *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 41 (Bankr. D. Colo. 1999) (“[T]he legislative purpose underlying [Chapter 9] . . . is to allow an insolvent municipality to restructure its debts in order to continue to provide public services.”).

the city's police department remains "woefully understaffed."²¹¹ Even while it was in bankruptcy, Vallejo was unable to borrow money to maintain its streets or replace police or fire vehicles.²¹² After the city cut its police and fire forces by nearly 50%, incidences of violent crime rose.²¹³ Although Chapter 9 helped the city save \$34 million through debt adjustments and rejection of labor agreements, Vallejo spent over \$13 million on legal fees related to the bankruptcy proceeding.²¹⁴ After emerging from bankruptcy, Vallejo was unable to access the debt markets to obtain additional funding because, despite its financial reorganization, it still could not afford to pay for interest on loans.²¹⁵ A post-bankruptcy analysis confirmed that because Vallejo had not been able to significantly reduce labor costs, a key goal of its bankruptcy filing, the bankruptcy had been unsuccessful.²¹⁶ Today, Vallejo remains "beset by poverty, gangs and crime."²¹⁷ As one commentator put it, anyone looking at Vallejo's bankruptcy "has to question a process that takes three years to complete and results in confirmation of a plan of adjustment that leaves the city with a \$3.4 million dollar shortfall in its first post-bankruptcy budget."²¹⁸ In the end, Vallejo's condition got worse, not better, after its bankruptcy filing.²¹⁹

Jefferson County, Alabama remains under court oversight as it struggles with debt in the aftermath of its bankruptcy. Although Jefferson County emerged from bankruptcy in 2013, a group of local residents and leaders have continued to fight to void parts of the county's bankruptcy plan.²²⁰ The group has filed a federal lawsuit against Jefferson County, arguing that a sewer rate increase included in the county's plan treats residents unfairly and places the county's most vulnerable residents at

²¹¹ Melanie Hicken, *Once Bankrupt, Vallejo Still Can't Afford Its Pricey Pensions*, CNN MONEY (Mar. 10, 2014, 10:44 AM), <http://money.cnn.com/2014/03/10/pf/vallejo-pensions/> [<http://perma.cc/K2RS-6QDU>].

²¹² PEW CHARITABLE TRUSTS, *THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS* 14 (2013), http://www.pewtrusts.org/~media/assets/2013/07/23/pew_state_role_in_local_government_financial_distress.pdf [<https://perma.cc/972Q-8ADT>].

²¹³ *Id.*

²¹⁴ *Id.*; see also Bobby White, *Bankruptcy Exit Approved for City*, WALL STREET J. (Aug. 6, 2011) (on file with the Utah Law Review), <http://www.wsj.com/articles/SB10001424053111903885604576486402778541450>.

²¹⁵ White, *supra* note 214.

²¹⁶ Jane Wells, *A New Chapter for Vallejo*, CNBC (July 28, 2011, 5:05 PM), <http://www.cnbc.com/id/43932782> [<https://perma.cc/5D5R-28HS>] (citing a report from Bank of America).

²¹⁷ Ellen Knickmeyer, *California Earthquake Marks First Major Test of Hard-Luck City of Vallejo After Bankruptcy*, CANADIAN BUS. (Aug. 26, 2014), <http://www.canadianbusiness.com/business-news/california-earthquake-marks-first-major-test-of-hard-luck-city-of-vallejo-after-bankruptcy/> [perma.cc/3EGW-2MSU].

²¹⁸ Denniston, *supra* note 102, at 273.

²¹⁹ See Wolfe, *supra* note 104, at 558 ("Vallejo's problems worsened after its discharge from bankruptcy.").

²²⁰ Verna Gates, *Alabama County Ratepayers Say Sewer Bankruptcy Settlement Too Pricey*, REUTERS (July 21, 2014, 6:03 PM), <http://www.reuters.com/article/2014/07/21/usa-bankruptcy-jeffersoncounty-idUSL2N0PW1SN20140721> [<https://perma.cc/7THQ-5W4G>].

risk.²²¹ In court, representatives of the group have also argued that the city's debt adjustment plan has increased, rather than decreased, the county's overall debt.²²² The County is also facing litigation over whether the bankruptcy court's authority to oversee sewer rates is constitutional.²²³ Thus, Jefferson County continues to fight legal, political, and financial battles²²⁴ even after emerging from Chapter 9, and questions remain over whether the county's plan treated creditors in accordance with bankruptcy law.²²⁵

A post-bankruptcy policy analysis for Orange County, California concluded that the county remained vulnerable years after its exit from bankruptcy. The report determined that the bankruptcy had disproportionately affected the county's poor: "[t]heir services were cut during the bankruptcy" and had not, even two years after emergence, "been fully restored."²²⁶ The report also concluded that by filing for bankruptcy, Orange County had ruined its credit, worsened relations with other local governments, and had "painted itself into a corner" in order to repay those governments.²²⁷ In other words, rather than strengthening Orange County's financial condition, the municipal bankruptcy process had created challenges, making it difficult for the county to succeed financially.

Although it has not yet emerged from bankruptcy, San Bernardino, California, which has spent over three years in Chapter 9, recently defaulted on \$10 million in bond payments²²⁸ and warned that it may have to contract out essential services to

²²¹ *Id.*

²²² *Id.*; see also Chung, *supra* note 58, at 699 (noting that Jefferson County's debt "has not gone away").

²²³ Frank Shafroth, *The Intergovernmental & Governance Challenges to Municipal Sustainability*, GMU MUN. SUSTAINABILITY PROJECT (June 18, 2015), <https://fiscalbankruptcy.wordpress.com/2015/06/18/the-intergovernmental-governance-challenges-to-municipal-sustainability/> [<https://perma.cc/Z2A6-S4N9>].

²²⁴ In early 2015, a report surfaced that Jefferson County was still paying millions of dollars in fees to its bankruptcy attorneys. See Barnett Wright, *Why Jefferson County Still Pays Millions to Lawyers for a Bankruptcy That Ended in 2013*, AL.COM. (Mar. 16, 2015, 9:47 AM), http://www.al.com/news/birmingham/index.ssf/2015/03/why_jefferson_county_continues.html [<https://perma.cc/P8XA-JYLL>].

²²⁵ The city of Desert Hot Springs, California, is another example of how Chapter 9 is not always able to help municipalities restructure unsustainable debt. The city filed for bankruptcy in 2001 and, as of 2014, was still struggling to pay off the \$9.7 million in bond debt that it had borrowed to pay off its largest creditor from the bankruptcy. See Juan Verala Luz, *Desert Hot Springs, California, Declares "Fiscal Emergency"*, WSWS (Jan. 15, 2014), <http://www.wsws.org/en/articles/2014/01/15/dhs-j15.html> [<https://perma.cc/S8UH-U2UJ>].

²²⁶ PUB. POLICY INST. OF CAL., *supra* note 178, at 14.

²²⁷ *Id.* at 16. Despite the report's conclusion that Orange County's credit had been hurt, Orange County was able to borrow from new lenders during and after its bankruptcy proceeding. See Kordana, *supra* note 111, at 1077 ("[N]ew lenders stepped forward during Orange County's bankruptcy proceedings despite the very real prospect that old lenders would not be paid in full.").

²²⁸ Tim Reid, *Exclusive: San Bernardino Has Defaulted on \$10 Million in Bond Payments*, REUTERS (Mar. 17, 2015, 10:52 PM), <http://www.reuters.com/article/2015/03/18/>

the county or state.²²⁹ The city is facing enormous pressure from its police and firefighter unions to produce a viable bankruptcy plan, and voters have rejected a ballot measure to reduce pay for police and firefighters.²³⁰ These events have left San Bernardino at an impasse in its bankruptcy case.²³¹ Legal fees are projected to reach \$10 million, representing nearly a quarter of the city's budget deficit.²³² San Bernardino's impending inability to provide essential services is the opposite of the result Chapter 9 is supposed to help it achieve.

It would be foolish to conclude that bankruptcy provides a solution to all of the problems affecting a city or town, and it would be equally foolish to suggest that the entities profiled above entered bankruptcy with the expectation that all of their problems would be resolved at no cost. Yet, the bankruptcy process has often served to root these municipalities more deeply into poor financial conditions. Bankruptcy is not preparing these entities for financial stability, and the examples above illustrate that municipalities that emerge from bankruptcy often have a difficult time resolving their problems and managing their debts.²³³ While they are in bankruptcy, these municipalities rack up substantial legal costs, diverting resources away from debt adjustment mechanisms and toward litigation with holdout creditors.

Of course, part of the problem may lie not with the bankruptcy process itself but with the fact that municipalities cannot liquidate.²³⁴ A business in a Chapter 11 case may liquidate, selling off its assets, if it is determined that the business will continue to struggle in the aftermath of a bankruptcy. Municipal entities, in contrast, usually continue to operate, even if rehabilitating them is disproportionately difficult. In certain cities, conditions may be so poor that it is impossible to rehabilitate the municipality without incurring significant collateral consequences. Although liquidation is not an option for cities, dissolution may be; however, a municipality must pay its debts before it can dissolve, and creditors cannot force a

us-usa-municipals-bernardino-exclusive-idUSKBN0MD2LL20150318 [https://perma.cc/TY8Z-PNSS].

²²⁹ Tim Reid, *Bankrupt San Bernardino, Calif., Warns It May Contract Out Services, Raise Debt*, REUTERS (Nov. 6, 2014, 6:48 PM), <http://www.reuters.com/article/2014/11/06/us-municipals-bernardino-idUSL1N0SW3HB20141106> [https://perma.cc/HAW9-FAW2].

²³⁰ *Id.*

²³¹ *Id.*

²³² Tim Reid, *Exclusive: Bankrupt San Bernardino Has Paid \$6 Million Legal Fees, Millions More Expected*, REUTERS (Dec. 3, 2014, 10:50 AM), <http://www.reuters.com/article/2014/12/03/us-usa-municipals-sanbernardino-idUSKCN0JH1PM20141203> [http://perma.cc/K74J-KPPM].

²³³ Although it is difficult to pinpoint a measure of success for a city in bankruptcy, economic viability may be one measure of success. See Michelle M. Harner & Jamie Marincic Griffin, *Facilitating Successful Failures*, 66 FLA. L. REV. 205, 214 (2014) ("An optimal restructuring . . . facilitates the reorganization of economically viable firms.").

²³⁴ Although cities cannot liquidate in the same way that a business can, they can "dissolve," or unincorporate. See generally Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L.J. 1364, 1367 (2012) ("A municipality can dissolve in order to disincorporate permanently . . .").

city's dissolution the way that they can force a business to liquidate.²³⁵ Although municipal bankruptcy is not currently seen as a complementary measure to municipal dissolution, perhaps it should be explored as such, given the difficulty of rehabilitating certain municipalities.

In their classic article, *When Cities Go Broke*, Professors Michael McConnell and Randal Picker stated, “[t]he premise of municipal bankruptcy law is that the city will emerge from bankruptcy in the same form—with the same boundaries, resources, functions, and governing structure—with which it entered bankruptcy.”²³⁶ It has now been over twenty years since that article's publication, and the cities and towns that have filed during that time illustrate that municipal bankruptcy fails to meet this basic premise. Although a city that emerges from bankruptcy these days may arguably retain its boundaries, its resources have often taken a dramatic hit, and the functions and services it once provided may no longer be readily available.

As the examples in this Article illustrate, cities and towns that enter Chapter 9 pay a large sum of money and expend a lot of resources to adjust only some of their debts and to engage in an expensive tug-of-war with holdout creditors and contract counterparties. In the end, many of these municipalities are still mired in financial and structural trouble upon emerging from bankruptcy,²³⁷ whether due to unresolved debt or pension issues, political problems, or new debts from legal fees incurred during the bankruptcy.²³⁸ For these entities, Chapter 9 functions as bankruptcy without bite, a costly and time-consuming process that fails to meet its basic goals. To quote one practitioner, “it remains unclear whether Chapter 9 is an effective tool to comprehensively restructure municipal bond debt.”²³⁹ Although defenders continue to rally around Chapter 9 as the last best option for struggling municipalities, the outcomes for cities that have utilized Chapter 9 should lead policymakers to question whether the current system makes sense and how it might be improved.

²³⁵ *Id.* at 1381–82.

²³⁶ McConnell & Picker, *supra* note 8, at 427; *see also* David S. Kupetz, *Municipal Debt Adjustment*, 42 FED. LAW. 18, 18 (1995) (“Chapter 9 of the Bankruptcy Code . . . is designed to enable a financially distressed municipality to continue to provide essential services to residents while working out a plan to adjust its debts.”).

²³⁷ *See, e.g.*, Joe Barrett & Ben Kesling, *Detroit Hit by Power Outage As Infrastructure Is Blamed*, WALL STREET J. (Dec. 2, 2014, 6:14 PM) (on file with the Utah Law Review), <http://www.wsj.com/articles/power-outage-hits-downtown-detroit-1417539066> (quoting Detroit's mayor as saying, “The bankruptcy order doesn't solve the decades of neglect in our infrastructure”).

²³⁸ Regarding fees, § 943(b)(3) of the Bankruptcy Code requires municipal debtors to disclose all amounts to be paid for services and expenses in the bankruptcy case and also requires all amounts to be reasonable. 11 U.S.C. § 943(b)(3) (2012). The Code does not, however, “authorize the allowance or require the payment of professional-fee claims. Generally, the [municipal] debtor's obligation to pay professionals will be governed by nonbankruptcy law.” DABNEY ET AL., *supra* note 50, at 68 (citing *Cty. of Orange v. Merrill Lynch & Co., Inc. (In re Cty. Of Orange)*, 241 B.R. 212 (Bankr. C.D. Cal. 1999)). For more information, *see Id.* at 57–72.

²³⁹ Kevane, *supra* note 73, at 3.

B. A Failure of Bankruptcy Law

Chapter 9 contravenes many of the broader goals of bankruptcy law. Chapter 9's wide application to entities from a sewer district to an entire county makes it difficult for courts to develop uniform rules and workable precedent to apply in municipal bankruptcy. The lack of clear rules in turn prevents Chapter 9 from providing the predictable, orderly approach to restructuring that bankruptcy law is supposed to embody.²⁴⁰ Sparse relevant case law, combined with unclear standards for eligibility and confirmation,²⁴¹ makes Chapter 9 difficult to use as a bankruptcy tool and can even lead to confusion when the municipality is initially developing its funding sources and debt issuances.²⁴²

Chapter 9 is an overextension of Chapter 11 bankruptcy, one that is asserted to address problems, such as political instability and governance issues, that bankruptcy was never designed or intended to address. On a practical level, the cumbersome interplay between state authorization and federal law creates eligibility and confirmation hurdles that make municipal bankruptcy cases difficult to administer.²⁴³

Although both Chapter 9 and Chapter 11 are designed to achieve basic bankruptcy outcomes, the chapter-specific incentives leading to those outcomes are very different. As discussed above, municipalities cannot be liquidated in a bankruptcy and must continue to provide vital health and safety services to their citizens.²⁴⁴ In contrast, citizens do not typically rely on corporations for the provision of health and safety services, and corporations may be liquidated if it is determined that the corporation is no longer valuable as a going concern. These differences drive the different goals underlying each chapter. Chapter 11 exists to maximize the value of the entity utilizing it; Chapter 9 exists so that a municipality may survive.²⁴⁵

²⁴⁰ See David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUS. L. REV. 1063, 1089 (2013) (arguing that a bankruptcy mechanism for states would provide a “predictable and orderly approach”).

²⁴¹ See, e.g., Bill Rochelle & Sherri Toub, *Detroit Judge Steven Rhodes Used Conscience to Approve Plan*, 26 BANKR. L. REP. (BNA) 1593, 1600 (2014) (noting that Judge Rhodes answered the most difficult questions with respect to Detroit's debt-adjustment plan “by looking to his conscience and sense of morality”).

²⁴² See Epling et al., *supra* note 146, at 237 (“Predictability would do much to ensure that municipal authorities . . . can accurately assess their bankruptcy options when structuring a revenue bond issuance . . .”).

²⁴³ For example, shortly after Detroit filed for bankruptcy, questions arose over whether the city could use Chapter 9 to restructure accrued pension benefits in light of provisions in the Michigan Constitution prohibiting the impairment of contractual obligations as well as pension obligations. See Chung, *supra* note 14, at 776–77.

²⁴⁴ See *supra* note 234 and accompanying text.

²⁴⁵ Andrew B. Dawson, *Pensioners, Bondholders, and Unfair Discrimination in Municipal Bankruptcy*, 17 U. PA. J. BUS. L. 1, 5 (2014) (“[W]hile Chapter 11 serves the dual . . . purposes of promoting reorganization and of maximizing returns to creditors,

Modeling the bulk of Chapter 9 on a Bankruptcy Code section aimed at fulfilling different purposes for different types of entities makes little sense.

Although the purposes of Chapter 11 and Chapter 9 are vastly different, both chapters are designed to embody bankruptcy's ability to carry out key functions, such as contract modification, elimination of debt overhang, and overcoming the holdout creditor.²⁴⁶ The Chapter 11 toolkit largely achieves these functions in the Chapter 11 context. Chapter 9, however, needs different tools to achieve these same results, tools that are lacking in Chapter 9's current incarnation.²⁴⁷

This does not mean that a federal bankruptcy option is useless for municipalities. In fact, there may be great value in allowing municipalities to take advantage of federal bankruptcy law.²⁴⁸ Alternatives to Chapter 9, such as bailouts or state financial distress programs, often either do not work, leaving cities to struggle for years,²⁴⁹ or, in the case of bailouts, work too well, possibly creating incentives for cities to be lax in their financial monitoring.²⁵⁰ Furthermore, only federal law can provide for nonconsensual contract modification,²⁵¹ and in other contexts, bankruptcy law has succeeded in achieving the objectives outlined above. Unfortunately, Chapter 9 in its current form simply does not serve the purposes that bankruptcy law was designed to fulfill.

Chapter 9's purpose is solely to confirm a debt composition plan."); Kimhi, *supra* note 59, at 673.

²⁴⁶ See *supra* section III.A.

²⁴⁷ Perhaps because of these different goals, there may be different stigmas associated with using Chapter 9 or Chapter 11. For example, Chapter 11 may be associated more with rehabilitating a business than with an admission of failure. In contrast, Chapter 9 may be viewed as a tool of last resort, to be used only when all other options have failed. This may explain why many businesses have taken advantage of Chapter 11, while few municipalities have turned to Chapter 9.

²⁴⁸ See Skeel, *supra* note 240, at 1082 (arguing that recent municipal bankruptcies "have signaled that Chapter 9 is indeed an option—and an alternative to rescue financing").

²⁴⁹ For example, Pennsylvania encourages its struggling cities to utilize Act 47, a state receivership and coordination program, in lieu of Chapter 9. Cf. David DeKok, *Broke Shamokin, Pennsylvania, Seeks State Crutch That Few Cast Off*, REUTERS (May 2, 2014, 7:00 AM), <http://www.reuters.com/article/2014/05/02/usa-pennsylvania-municipals-idUSL2N0N91ZV20140502> [perma.cc/EMT7-YMJX]. Unfortunately, municipalities often remain in the program for decades. See *id.* The city of Scranton, for example, has been designated "as distressed under the Act since 1992." Steve McConnell, *Westfall Twp.'s First-in-the-State Bankruptcy May Not Be Pennsylvania's Last*, SCRANTON TIMES-TRIBUNE.COM (Mar. 22, 2010), <http://thetimes-tribune.com/news/westfall-twp-s-first-in-the-state-bankruptcy-may-not-be-pennsylvania-s-last-1.695242> [perma.cc/2MWY-8QTF].

²⁵⁰ See, e.g., Skeel, *supra* note 240, at 1080 (noting that the case for adopting formal restructuring rules is very strong when either bailout or default is the most likely outcome in a crisis).

²⁵¹ 11 U.S.C. § 903(1) (2012) ("[A] State law prescribing a method of composition of indebtedness . . . may not bind any creditor that does not consent to such composition . . .").

A key principle of bankruptcy law is the fair and equitable treatment of creditors' claims.²⁵² In Chapter 9, however, it is admittedly difficult to figure out how to achieve this treatment. Unlike in a business case, where the relative priorities of secured creditors, unsecured creditors, and equity holders are generally established, in a Chapter 9 case, the priorities are not so clear.²⁵³ Concerns about who should bear most of the risk of a Chapter 9 debtor's nonpayment continue to dominate discussions in both scholarly literature and in case law.²⁵⁴ The law is also in flux about when a municipality must attempt to raise revenues (for example, by

²⁵² See Hynes & Walt, *supra* note 150, at 613 ("Bankruptcy law begins with the principle of an equal distribution among creditors . . ."); Skeel, *supra* note 23, at 703 ("But the principle of equal treatment of similarly situated creditors is deeply entrenched, and bankruptcy law is designed to encourage a fair distribution of the sacrifice.").

²⁵³ For example, in Detroit's bankruptcy case, the city's proposal to pay its retirees more than its bond investors was contested by bond insurers who argued that such a distribution would be illegal. See Steven Church, *Detroit Bond Insurer Says Plan Causes 'Serious Mayhem'*, BLOOMBERG (Sept. 3, 2014, 11:33 AM), <http://www.bloomberg.com/news/2014-09-03/detroit-bond-insurer-says-plan-causes-serious-mayhem.html> [<https://perma.cc/U3YQ-AQQJ>]. The bankruptcy judge was tasked with deciding this issue as part of his determination as to whether Detroit's plan was "fair and feasible." *Id.*; see also B. Summer Chandler, *Is It "Fair" to Discriminate in Favor of Pensioners in a Chapter 9 Plan?*, AM. BANKR. INST. J., Dec. 2014, at 22, 22 (discussing the issue of whether a plan of adjustment may be approved if it provides a greater recovery to pensioners compared with recoveries offered to other creditors of the same priority); Steven Church, *San Bernardino Sued for Favoring Pensions over Bondholders*, BLOOMBERG (Jan. 8, 2015, 8:46 AM), <http://www.bloomberg.com/news/articles/2015-01-08/san-bernardino-sued-for-favoring-pensions-over-bondholders-1> [<http://perma.cc/THV8-NP48>] (describing the lawsuit against San Bernardino for continuing to pay the state's retirement system without giving equal treatment to pension bondholders); Dawson, *supra* note 245, at 7 (noting that there are no priority unsecured claims in municipal bankruptcy other than administrative expense claims).

²⁵⁴ For example, in the City of Stockton's bankruptcy case, the judge confirmed Stockton's plan of adjustment even though it contemplated paying retirees a greater share of what they were owed than other creditors. See Mary Williams Walsh, *Judge Approves Bankruptcy Exit for Stockton, Calif.*, N.Y. TIMES (Oct. 30, 2014, 3:35 PM) (on file with the Utah Law Review), <http://dealbook.nytimes.com/2014/10/30/judge-approves-bankruptcy-exit-for-stockton-calif/>. Prioritizing retirees in this manner is not clearly contemplated by the Bankruptcy Code, and some scholars thus believe that the Stockton plan is bad bankruptcy law. See C. Scott Pryor, *BIG News from Stockton. Maybe.*, PRYOR THOUGHTS (Oct. 2, 2014), <http://pryorthoughts.blogspot.com/2014/10/big-news-from-stockton-maybe.html> [<http://perma.cc/Z99P-QNVK>]; C. Scott Pryor, *Stockton Confirmed!*, PRYOR THOUGHTS (Oct. 31, 2014), http://pryorthoughts.blogspot.com/2014/10/stockton-confirmed.html?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+PryorThoughts+%28Pryor+Thoughts%29 [<http://perma.cc/42FW-HKHJ>]; see also Romy Varghese, *California Issuers Risk Higher Costs with Stockton: Muni Credit*, BLOOMBERG (Dec. 22 2014, 11:33 AM), <http://www.bloomberg.com/news/2014-12-22/california-issuers-risk-higher-costs-with-stockton-muni-credit.html> [<http://perma.cc/89K8-9X9M>] (noting that, because Stockton's plan paid certain investors less than they were owed, other California localities may see borrowing costs rise).

taxing) before it can impose cuts on its creditors and whether a municipality that seeks to impair one group of creditors must treat other creditors similarly.²⁵⁵ Uncertain outcomes in Chapter 9 may give municipalities an incentive to settle with creditors instead of allowing a court to decide the issue.²⁵⁶ These settlements have the advantage of allowing the municipality to avoid cramming down a plan over the objections of creditors. Yet, the settlements impose their own costs by decreasing the amount of assets available to be split among the remaining creditors. Furthermore, if Chapter 9 becomes simply about forcing parties to settle, the municipality must pay a heavy entrance fee to those settlement negotiations in the form of the eligibility battle that is almost certain to occur at the start of the Chapter 9 case.²⁵⁷

The basic dichotomy between economic and financial distress further illustrates the difficulty with using Chapter 11 rules in Chapter 9. The economic/financial distress dichotomy is used in bankruptcy literature predominantly to distinguish between two types of financial distress facing corporations.²⁵⁸ Economic distress results when a corporation's operating expenses are consistently higher than its revenues, while financial distress occurs when a corporation faces a short-term inability to pay back debts. Bankruptcy may be seen as an ineffective mechanism for combating economic distress, but as an effective mechanism for dealing with financial distress. This is because bankruptcy may do little to address the underlying, operational problems of an economically distressed entity, but bankruptcy can help remedy a short-term debt problem by eliminating these debt obligations and allowing the entity to continue to function as a going concern.

In the municipal context, however, a municipality's economic and financial problems are often inextricably intertwined.²⁵⁹ A municipality's financial situation is very often governed by the same substantive laws, policies, and procedures by which the municipality itself is governed. If bankruptcy is a tool to predominantly address financial distress, other mechanisms will be necessary in every municipal case to address the causes of the municipality's economic distress. Chapter 9 on its own cannot provide this remedy.²⁶⁰ Further, a municipality's economic and financial problems are in turn intertwined with state and federal problems. Unlike a business,

²⁵⁵ Lee R. Bogdanoff, *Understanding Chapter 9 in Today's Economic Environment*, in CHAPTER 9 BANKRUPTCY STRATEGIES 49 (2011).

²⁵⁶ B. Summer Chandler & Mark S. Kaufman, *Maybe Taxes Aren't So Certain: What Is "Fair and Equitable" in a Chapter 9 Plan?*, AM. BANKR. INST. J., Feb. 2013, at 12, 13.

²⁵⁷ See *supra* section II.B.

²⁵⁸ See, e.g., Skeel, *supra* note 41, at 2235 (“[T]here is a well recognized distinction between economic failure (a firm should be shuttered) and financial failure (liabilities exceed assets).”).

²⁵⁹ See *supra* section III.A.4.

²⁶⁰ See, e.g., Alison Vekshin & Michael Bathon, *Stockton's Costly Bankruptcy May Not Tempt Other Cities*, BLOOMBERG (Oct. 30, 2014, 10:01 PM), <http://www.bloomberg.com/news/2014-10-31/stockton-s-costly-bankruptcy-may-not-tempt-other-cities.html> [<http://perma.cc/9H9V-JYTS>] (noting that Stockton's exit from bankruptcy “doesn't change the difficult economic environment”).

a municipality is never truly a discrete entity—it is always a creature of the state and/or federal government.

In short, although Chapter 9 and Chapter 11 share some key bankruptcy purposes, such as resolution of the holdout creditor problem²⁶¹ and the elimination of debt overhang,²⁶² Chapter 9 needs a vastly different toolkit to achieve those goals. In theory, Chapter 9 was designed to help struggling municipalities regain their footing by imbuing them with greater powers. But in practice, Chapter 9's use of Chapter 11's tools brings together a group of seriously weakened agents. To move forward, it is necessary to articulate and clarify the role federal bankruptcy law should play in municipal distress, establish a new toolkit for municipal debtors, and clearly delineate the roles various intertwined entities—municipalities, states, and the federal government—should play in alleviating municipal financial distress.²⁶³

IV. MOVING FORWARD

Discussed previously, Parts II and III illustrate that Chapter 9's toolkit, modeled off of Chapter 11, fails to achieve the aims of bankruptcy generally and those of Chapter 9 in particular. Instead of adapting Chapter 9 as each new municipal crisis unfolds, the time is ripe to focus on holistic reform. If federal bankruptcy is to remain an option for municipalities, the structure of Chapter 9 must be reconsidered.

Using the analysis from Parts II and III, Part IV suggests several starting points for Chapter 9 reform, each seeking to align Chapter 9 with bankruptcy law and make Chapter 9 more effective as a bankruptcy tool.²⁶⁴ Section A identifies three broad

²⁶¹ See Kimhi, *supra* note 16, at 357, 363–65; see also *To Amend the Bankruptcy Act Municipal and Private Corporations: Hearing Before the H. Comm. on the Judiciary*, 73d Cong. 22 (1933) (statement of Rep. J. Mark Wilcox) (“In every instance where a governmental unit finds itself in financial difficulty and is able to make some satisfactory agreement of adjustment with the majority of its creditors, there is always a small minority who hold out and demand preferential treatment. These minority creditors are prompted in this action by the thought that someone will buy them out rather than have the whole plan collapse.”); McConnell & Picker, *supra* note 8, at 454 (“Municipal bankruptcy law thus originated from a desire to control minority holdouts, and arose in a context of substantial uncertainty over the appropriate relationship between federal and state law. These issues still resonate in the current Chapter 9.”).

²⁶² See Vincent S.J. Buccola, *An Ex Ante Approach to Excessive State Debt*, 64 DUKE L.J. 235, 272 (2014) (“Chapter 9 is thus oriented toward a singular function—the elimination of debt overhang.”); see also Skeel, *supra* note 23, at 687 (“[B]ankruptcy may also be necessary to solve a debt overhang problem.”).

²⁶³ See generally Christopher J. Tyson, *Municipal Identity as Property*, 118 PA. ST. L. REV. 647, 695 (2014) (observing that state boundary laws may contribute to central city financial instability and suggesting that boundary policies be reconsidered in the course of a municipal bankruptcy).

²⁶⁴ As a starting point, this Article accepts the idea that federal bankruptcy is an option that can and should be available for municipalities. The options described in this Part are designed to realign Chapter 9 with federal bankruptcy principles and goals and are not meant to be wholesale replacements for the federal bankruptcy process.

areas of focus for reform: a holistic re-design of Chapter 9 so that it is no longer an offshoot of Chapter 11; reconsideration of the balance between federal relief and state sovereignty; and new roles for taxpayers, the region, and the state. Section B provides guidance on the timing and use of these reforms, cautioning that even with the advocated reforms, municipal relief should be tailored whenever possible to account for the broad scope of problems different municipal entities could face.

A. *Overhaul and Reform*

Reforming Chapter 9 outright poses many challenges. Many of the reforms that would give Chapter 9 more clout as a bankruptcy mechanism, such as allowing the judge to play a greater role in the case, appointing a trustee to manage the case, or giving debtors the ability to renegotiate more types of debt, would run afoul of state sovereignty concerns.²⁶⁵ Although granting the bankruptcy court more power to, for example, sell property or raise taxes, would certainly provide more opportunity for creditor involvement in the bankruptcy case, any move toward increasing federal power in municipal bankruptcy is likely to meet with great resistance due to the concerns discussed above over federal intrusion into state sovereignty.²⁶⁶ Proposals to allow bankruptcy to give municipalities a true fresh start by allowing for reincorporation or the drawing of new boundary lines, for example, raise similar concerns.

It is also difficult to reform Chapter 9 because municipalities must continue to provide essential services to their constituents even while they are in bankruptcy. This requirement means that many typical bankruptcy benefits, such as the breathing space provided by the automatic stay,²⁶⁷ will likely remain diminished regardless of how Chapter 9 is changed. Furthermore, given a municipality's inevitable political interactions, federal bankruptcy is likely to remain an incomplete remedy in the municipal context, since bankruptcy is ill-equipped to address political problems.

Nevertheless, these difficulties should not prevent reforms where reform is possible to increase predictability and consistency with bankruptcy law. There are three primary areas of focus for future reform: (1) providing Chapter 9 its own toolkit; (2) redefining the balance between state sovereignty and federal bankruptcy law; and (3) establishing new roles for the key players in a municipal bankruptcy. Each of these areas is described in greater detail below.

²⁶⁵ See *supra* section II.A (discussing the Supreme Court's views in the *Ashton* and *Bekins* cases regarding potential Tenth Amendment problems with giving other parties power to interfere with the states).

²⁶⁶ See Freyberg, *supra* note 17, at 1023 (reviewing various proposals designed to increase the power of the bankruptcy court and suggesting that such proposals would likely be "dead on arrival" at Congress").

²⁶⁷ See 11 U.S.C. § 362 (2012).

1. *Redesign*

The first area of focus should be redesigning Chapter 9 as its own independent form of bankruptcy relief. Bankruptcy law serves valuable purposes, but Chapter 9 needs its own set of rules to achieve those purposes. As described above, the entities Chapter 9 is designed to help look very different from the entities for which Chapter 11 was created. Nevertheless, Chapter 9 is based primarily off of Chapter 11. It makes little sense for Chapter 11 to serve as the baseline for Chapter 9.²⁶⁸ Although a complete overhaul of Chapter 9 will require extensive study, this Article's examination of how Chapter 11 principles have failed to work in Chapter 9 suggests clear areas of focus for concrete modification of Chapter 9. The following broad proposals are meant to provide guidance and starting points to consider for reform.

In redesigning Chapter 9, specific focus should be placed on developing rules that clarify current areas of confusion. This is particularly true with respect to plan confirmation rules, such as those concerning feasibility and cramdown. Judges should not have to rely on their "conscience," as the judge in Detroit's bankruptcy did,²⁶⁹ to articulate what makes a plan of adjustment feasible and fair in the Chapter 9 context, nor should they have to rely on standards from Chapter 11 that are confusing when applied to Chapter 9. A new focus on development of Chapter 9-specific standards should make judges more comfortable cramming down a plan over the objections of creditors. Establishment of Chapter 9-specific rules should also provide more clarity about the priority of claims in Chapter 9 and whether and how municipal contracts can be modified.

A consequence of strengthening municipalities' relief under Chapter 9 is the effect on borrowing costs for municipalities. If municipal debtors can more easily cram down a plan over objections, for example, concerned creditors may increase the cost of borrowing for municipalities. Although further study into whether and how proposed changes to Chapter 9 affect borrowing costs is certainly warranted, under the current situation, municipalities that have gone through Chapter 9 bankruptcy face the prospect of both ineffective relief and higher borrowing costs. If the bankruptcy process can be used to put a municipality on firmer footing, increasing the municipality's long-term stability and control over its debts, perhaps future borrowing costs will not be as high.

Any redesign of Chapter 9 should also consider utilizing separate rules and procedures for special-purpose municipal entities. These entities, which include school, hospital, water, and sewer districts, look very different in form and structure from general-purpose municipalities, such as the cities, towns, and counties that

²⁶⁸ Indeed, some scholars have even noted that municipal bankruptcy is more akin to individual bankruptcy than business bankruptcy. *See, e.g.,* Gillette, *supra* note 14, at 292 ("The effect is that municipal bankruptcy serves as a mechanism by which localities can obtain the equivalent of the fresh start available to individuals in bankruptcy, rather than the 'efficient reconfiguration of assets' characteristic of corporate bankruptcy.").

²⁶⁹ Rochelle & Toub, *supra* note 241, at 1600.

have served as this Article's focus. To the extent possible, Chapter 9 relief should be tailored so that each municipal entity utilizes procedures that take into account the structure, purpose, and creditors of each individual entity type. Of course, additional tailoring increases the information costs associated with operating under the rules, but when entities are so vastly different, it is worth considering whether Chapter 9 might simply be broken down into broad categories, with different rules applying for general-purpose and special-purpose entities.²⁷⁰

A potential consequence of a holistic redesign of Chapter 9 is that the "new" Chapter 9 may be more difficult for bankruptcy judges to administer. Currently, Chapter 9's similarity to Chapter 11 may appeal to bankruptcy judges, many of whom only rarely encounter municipal bankruptcies. It will take time for bankruptcy judges to learn about, use, and develop law in the "new" Chapter 9, possibly increasing unpredictability and instability in the law in the short term. Still, these difficulties are not insurmountable. The Bankruptcy Code as a whole is constantly undergoing scrutiny and reform. In fact, a recent proposal would substantially change the Chapter 11 process.²⁷¹ The possibility that any proposed changes will slow the law's development in the short term should be balanced against the need to have a system that can meet the goals it is designed to accomplish.

2. *A Better Balance*

A second area of focus should be on redefining the precarious and uncertain balance between state sovereignty and federal bankruptcy law that currently shapes Chapter 9. One way to do this is to focus on eligibility battles. Under the current system, a municipality must jump through two primary hurdles to receive access to Chapter 9 relief: it must receive state authorization to file for bankruptcy, and it must then meet all of the federal bankruptcy requirements for eligibility.²⁷² As demonstrated, this process creates costly litigation battles that municipalities must fight before they can access bankruptcy relief. One possibility for streamlining a

²⁷⁰ A similar proposal has been made in the Chapter 11 context, to better account for the differences between larger and smaller entities. *See* AKIN GUMP, AMERICAN BANKRUPTCY INSTITUTE (ABI) REFORM COMMISSION RELEASES REPORT RECOMMENDING SIGNIFICANT CHANGES TO CHAPTER 11, at 4 (2014), <https://www.akingump.com/images/content/3/4/v2/34347/American-Bankruptcy-Institute-ABI-Reform-Commission-Releases-R.pdf> [<https://perma.cc/KVA5-C2XK>] (describing the "creation of a new chapter 11 paradigm for small and middle-sized enterprises (SMEs)").

²⁷¹ *See generally* AM. BANKR. INST., COMMISSION TO STUDY THE REFORM OF CHAPTER 11: 2012–2014 FINAL REPORT AND RECOMMENDATIONS (2014) (on file with the Utah Law Review), <https://abiworld.app.box.com/s/vvircv5xv83aav14dp4h> (explaining proposals to change Chapter 11).

²⁷² *See supra* subsection II.B.1.

municipality's path to relief could involve putting the eligibility process entirely in state hands.²⁷³

Making the state the exclusive gatekeeper for Chapter 9 would still allow the state to "opt in" to federal bankruptcy relief for its municipalities. At the same time, eliminating the federal eligibility hurdles would make Chapter 9 more consistent with the goal of open access to bankruptcy court, while still respecting principles of state sovereignty.

Eliminating federal eligibility requirements could also substantially reduce the overall cost to municipalities of the Chapter 9 proceeding. As seen above, federal eligibility battles usually take several months and eat up a large fraction of a municipality's bankruptcy budget. Eliminating the federal eligibility requirements would mean that, while in bankruptcy, eligible debtors can more quickly focus their attention on developing a plan of adjustment and, ultimately, on getting back to work. In short, removing the federal eligibility hurdle could streamline the eligibility process without jeopardizing state sovereignty interests.

A side effect of eliminating the federal eligibility requirements is the further diminishment of the role of creditors in a Chapter 9 case. As previously discussed, eligibility hearings represent one of the few opportunities for creditors to get involved in a municipal bankruptcy.²⁷⁴ Taking this opportunity away from creditors may make them more likely to hold out at the confirmation stage; however, the development of more powerful cramdown rules in the Chapter 9 context, as suggested above, may help alleviate this problem.

Making the state the sole eligibility gatekeeper may also increase the role that state politics plays in municipal bankruptcy. A potential resolution to this issue is for states to create a special entity or agency to serve as a gatekeeper for state authorization. This agency could be composed of appointed bankruptcy experts within the state, rather than politicians. The presence of a more neutral entity could reduce the role of politics in eligibility proceedings, as discussed more fully below.

Regardless of whether eligibility remains in federal hands or shifts entirely to the state, it is critical to recognize that Chapter 9 is only a partial solution to the problem of municipal fiscal distress. More research is needed to determine what exactly Chapter 9 does best in order to subsequently determine which entities—state, federal, or both—should play the role of Chapter 9 "gatekeeper."

3. *New Roles*

The third and final area of focus for reform should be on reexamining the roles of the various parties affected by a municipal bankruptcy. The range of focus includes (a) taxpayers, (b) state government, and (c) regional bodies.

²⁷³ This idea could be accomplished via statutory modification to Chapter 9. For example, the federal eligibility requirements could be reduced to one requirement, which makes municipalities eligible if their state specifically authorizes them to be.

²⁷⁴ See *supra* notes 96–98.

(a) *Taxpayers*

Giving taxpayers a role to play in a Chapter 9 case as parties in interest would better align Chapter 9 with the due process ideal to allow parties affected by a case the ability to participate in that case.²⁷⁵ Allowing taxpayers in particular to intervene in a bankruptcy would also provide a counterpoint to those creditors whose primary interests lie not in keeping the municipality afloat but in getting paid at any cost.²⁷⁶ By enabling a multitude of voices and perspectives to be heard, Chapter 9 may serve as a more effective tool for the municipality to raise arguments that may not otherwise be addressed in bankruptcy.

The judge in Detroit recognized the importance of giving taxpayers a voice in municipal bankruptcy when he held a hearing to listen to nearly fifty Detroit residents who objected to Detroit's bankruptcy filing.²⁷⁷ Although allowing taxpayer interests to dominate a case at the expense of creditors and the debtor may be counterproductive, giving taxpayers a formal avenue to participate in the case may allow key issues to come to light and is consistent with the goals of bankruptcy law and due process more generally.²⁷⁸

The question of how much of a role to give taxpayers in the municipal bankruptcy process is worth further study.²⁷⁹ Giving taxpayers a direct vote on a municipality's plan of adjustment may stall the process unnecessarily or make the case unmanageable. For example, taxpayers, particularly in places where the political climate disfavors taxation, could vote down plans that call for even modest tax increases. On the other hand, making taxpayers a class that can vote on a plan may be less of a concern if the bankruptcy judge can effectively enforce the debtor's power to cram down an otherwise fair and feasible plan.

Of course, taxpayers are arguably already represented in a bankruptcy case through the municipal officials that they have elected to represent their interests. Still, when a community is in the midst of a bankruptcy that can drastically affect

²⁷⁵ See Coordes, *supra* note 205, at 408.

²⁷⁶ Similarly, the interests of taxpayers are often not aligned with the interests of officials. See Moberg & Wagner, *supra* note 55, at 33 ("In a municipal corporation, . . . the officials deciding how to spend the money are not guided by the incentive to maximize the value of their investments on behalf of their residents.").

²⁷⁷ Nathan Bromey & Matt Helms, *Citizen Objectors to Detroit Bankruptcy Get Day in Court*, USA TODAY (Sept. 19, 2013, 6:58 PM), <http://www.usatoday.com/story/news/nation/2013/09/19/detroit-bankruptcy-citizens-hearing/2839913/> [<https://perma.cc/3FCH-KT35>].

²⁷⁸ See Coordes, *supra* note 205, at 387–88 (making a similar argument for greater stakeholder participation in large Chapter 11 cases).

²⁷⁹ At least one scholar has already begun to formulate theories about the propriety and degree of taxpayer involvement in a Chapter 9 case. See generally C. Scott Pryor, *Who Bears the Burden? The Place for Participation of Municipal Residents in Chapter 9*, 37 CAMPBELL L. REV. 161 (2015) (providing that a committee should represent residents for the purposes of Chapter 9 plans); C. Scott Pryor, *Who Pays the Price? The Necessity of Taxpayer Participation in Chapter 9*, 24 WIDENER L.J. 81 (2015) (explaining how bankruptcy courts can address procedural and structural barriers to resident participation in Chapter 9 plans).

the living conditions of its residents, giving taxpayers the opportunity to explain for themselves how the bankruptcy will affect them will enhance the ability of representatives to address constituent concerns. Furthermore, giving taxpayers a voice may prevent some taxpayers from “voting with their feet” and simply leaving the municipality altogether. Thus, while the level of taxpayer participation in a municipal bankruptcy case need not rise to the point of giving them a direct vote on the plan, providing a formal avenue for taxpayers to communicate directly with the bankruptcy judge and officials involved in the bankruptcy would have significant benefits.

(b) *States*

States may also have a greater role to play in a Chapter 9 case; however, that role must be carefully considered. Scholars have argued that Chapter 9 is designed to work in conjunction with the state,²⁸⁰ and that state involvement is necessary for a municipality in distress.²⁸¹ The importance of state involvement in Chapter 9 is further emphasized by the fact that in some cases, the holdout creditors in a Chapter 9 case are not private creditors, but other governmental entities.²⁸² For example, CalPERS, a state agency, has been a key holdout creditor in many California municipal bankruptcies. These governmental entities, far from helping bankrupt municipalities, exacerbate the bankruptcy process in their role as holdout creditors. State involvement in municipal fiscal distress might therefore involve increased awareness of the roles state agencies play in a Chapter 9 case and coordination so that these agencies help the municipalities they are intended to work with.

State intervention into a municipality’s affairs has sometimes worked well. For example, scholars support an *ex ante* approach to state involvement, beginning with the time when the municipality is issuing debt.²⁸³ Some states, such as New York, have begun to move in this direction, requiring municipalities to report financial data

²⁸⁰ Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 415–16 (2014).

²⁸¹ *Id.* at 415 (“The real governance vacuum in Chapter 9 emerges when the state fails to provide any direction for the financial rehabilitation of its cities.”); *see also* PEW CHARITABLE TRUSTS, *supra* note 212, at 4–6 (providing guidance to states about whether and how “to assist municipalities facing fiscal stress”); Kimhi, *supra* note 59, at 637 (arguing that “state intervention is the most effective remedy for local financial crises”); Jones, *supra* note 109 (“States have an obligation to monitor what they have created.”).

²⁸² *See* Frank Shafroth, *Municipal Bankruptcy & the Role of Intergovernmental Relations*, GMU MUN. SUSTAINABILITY PROJECT (Aug. 18, 2015), <https://fiscalbankruptcy.wordpress.com/2015/08/18/municipal-bankruptcy-the-role-of-intergovernmental-relations/> [<https://perma.cc/UFS7-PY2B>] (noting that California’s “actions in recent years . . . have only served to exacerbate, rather than ameliorate San Bernardino’s fiscal problems”).

²⁸³ *See* Lessard & Ngo, *supra* note 140, at 399; *see also* Buccola, *supra* note 18, at 240 (arguing in favor of an *ex ante* approach to state financial distress).

to the state comptroller on a regular basis.²⁸⁴ Elsewhere, North Carolina is considered a shining example of ex ante state involvement.²⁸⁵ North Carolina's Local Government Commission reviews budgets and debt proposals from all of the state's municipalities on a regular basis.²⁸⁶ When a review signals that a locality may be facing fiscal trouble, the state puts the locality on a watch list and imposes strict guidelines for funding deals.²⁸⁷

Within Chapter 9 itself, state intervention has sometimes worked as well. The bankruptcy case of Central Falls, Rhode Island is often cited as an example of successful state involvement in municipal affairs.²⁸⁸ After the city of Central Falls asked to be put into receivership under state law, lawmakers quickly passed two different laws that preserved Central Falls' ability to continue borrowing funds.²⁸⁹ In contrast to many of the cities and towns profiled above, Central Falls emerged from bankruptcy in just over a year.²⁹⁰ The state's prompt intervention is widely credited with Central Falls' success.

Yet, there is no guarantee that what has worked in Rhode Island or North Carolina will work in other states. Due to variances in political climates and voter attitudes, states may be hampered in their efforts to intervene, or they may not be able—or willing—to intervene at all. Although scholars and policymakers have touted North Carolina's ex ante system for years, it is telling that other states have not adopted a similar system. In fact, some states have even moved in the opposite direction—the state of California, for example, has repeatedly demonstrated that it is not willing to provide oversight to most municipalities, either before or after the entity succumbs to distress.²⁹¹ In 1995, the governor of California vetoed a bill that would have created a Local Area Bankruptcy Committee that would perform a monitoring role for municipalities and eventually decide on bankruptcy

²⁸⁴ PEW CHARITABLE TRUSTS, *supra* note 212, at 23.

²⁸⁵ Kimhi, *supra* note 59, at 679 (“North Carolina is considered a model state in terms of local government finance.”).

²⁸⁶ *State and Local Government: Local Government Commission*, N.C. DEP'T STATE TREASURER, <https://www.nctreasurer.com/slg/Pages/Local-Government-Commission.aspx> [<https://perma.cc/7C8V-TJYY>] (last visited Feb. 26, 2016).

²⁸⁷ PEW CHARITABLE TRUSTS, *supra* note 212, at 34.

²⁸⁸ *Id.* at 4–5.

²⁸⁹ Hilary Russ, *Central Falls, Rhode Island Bankruptcy: Plan Saves Tiny City but Leaves Scars*, HUFFPOST BUS. (Sept. 3, 2012, 7:59 PM), http://www.huffingtonpost.com/2012/09/03/central-falls-rhode-island-bankruptcy_n_1852982.html [<https://perma.cc/UT6H-8E5L>].

²⁹⁰ Dunstan Prial, *In Rhode Island Bankruptcy, Bondholders Came First*, FOX BUS. (July 24, 2013), <http://www.foxbusiness.com/government/2013/07/24/in-rhode-island-bankruptcy-bondholders-came-first/> [<https://perma.cc/RVT4-MQLB>].

²⁹¹ PEW CHARITABLE TRUSTS, *supra* note 212, at 42; *see also* Frank Shafroth, *Protecting the Ability to Provide Essential Public Services*, GMU MUN. SUSTAINABILITY PROJECT (July 1, 2015), <https://fiscalbankruptcy.wordpress.com/2015/07/01/protecting-the-ability-to-provide-essential-public-services/> [<https://perma.cc/6Z52-GSMW>] (describing California's lack of cooperation with San Bernardino after the city's bankruptcy filing).

authorization.²⁹² The governor was concerned that the bill would inappropriately allow a state government instrument to “usurp” local authority.²⁹³ In other states, constituents may resist state involvement, believing that it is not the state’s responsibility to interfere in the municipality’s affairs.²⁹⁴

Even in states where increasing state intervention is feasible, proactive state intervention may cause more harm than good if the state interferes without taking the necessary time to develop an understanding of the municipality and the root causes of its problems. This requires an investment of time and effort at the state level just to create intervention programs and guidelines. State actors may also fail to act independently or may be subject to some of the same political influences as municipal officials. State intervention may even have an adverse effect on incentives at the municipal level. For example, municipal decision makers who believe that they can rely on a state bailout or other state assistance may lack the incentives to proactively pursue restructuring alternatives or financial reform.²⁹⁵

State intervention also comes at a cost. As states themselves face budgetary struggles, they may be disinclined to intervene in the affairs of their municipalities. Indeed, state budget problems may even contribute to the cause of municipal fiscal distress, as states struggling to meet their own budgets refuse to continue to fund or provide services to their cities and towns. Even if states do not provide direct monetary assistance to distressed municipalities, other forms of help, such as increased state-level monitoring, may divert resources and personnel away from addressing state-level responsibilities. Thus, although state intervention may certainly be beneficial, it is not clear that the state will be able to overcome countervailing reasons not to intervene.

State intervention methods may themselves fail or be too little, too late. Although early state intervention has arguably served to prevent municipal bankruptcies in some states,²⁹⁶ intervention efforts have not always worked well. For example, despite the existence of strong state oversight,²⁹⁷ many New Jersey municipalities are facing a looming pension crisis and other fiscal difficulties that

²⁹² Frederick Tung, *After Orange County: Reforming California Municipal Bankruptcy Law*, 53 HASTINGS L.J. 885, 903 (2002).

²⁹³ *Id.*

²⁹⁴ In Pennsylvania, for example, the prevailing citizen attitude is one of reluctance to accept offers of outside help, and even creditors are suspicious of any state involvement in municipal deals. *Opening Remarks Bankruptcy and Beyond* (Apr. 14, 2014) (opening remarks from Widener University School of Law’s Bankruptcy and Beyond Symposium). Thus, increasing state involvement in states like Pennsylvania may even hurt municipalities’ ability to obtain funding in the first place.

²⁹⁵ See Skeel, *supra* note 23, at 714–15 (describing incentives for states that may rely on a federal bailout).

²⁹⁶ PEW CHARITABLE TRUSTS, *supra* note 212, at 18, 24 (describing Massachusetts’ success with early state intervention and Pittsburgh’s use of long-term financial planning mechanisms to increase public pension contributions and pay down debt).

²⁹⁷ *Id.* at 36.

may lead them to bankruptcy's door.²⁹⁸ Additionally, although the state of Michigan regularly reviews local governments for signs of distress, it does not intervene until events indicating financial distress have already been triggered.²⁹⁹ This timing problem is exacerbated because the state is composed of diverse actors who can disagree about the appropriate level of involvement in municipal affairs, slowing down needed relief. For example, in New Jersey, State Senate President Stephen Sweeney recently criticized Governor Chris Christie for appointing an emergency manager for Atlantic City, pledging a "big fight" against any potential bankruptcy for the city.³⁰⁰

In short, state intervention, though valuable, may also do more harm than good in certain circumstances.³⁰¹ Nevertheless, given that local fiscal decisions often resonate on the state level, it is important for states to at least be aware of, if not involved in, local fiscal crises to the extent possible.³⁰² Reforming Chapter 9 to provide for an explicit role for state involvement in municipal bankruptcy, however, may not be feasible given the existing variance in state involvement. At the federal level, standardizing a way to give states control over a municipality's eligibility for bankruptcy may be the only feasible form of federally mandated state intervention.

(c) A Middle Ground: Regional Coordination

Regional coordination mechanisms, either in conjunction with or in lieu of state intervention, may also have a role to play in a new Chapter 9. As seen in Detroit's battle with its suburbs over the assets in the Detroit Institute of Arts museum, municipal fiscal issues may affect an entire region.³⁰³ Creating a regional fiscal

²⁹⁸ See Hilary Russ, *Moody's Slashes Atlantic City Rating on Bankruptcy Potential*, REUTERS (Jan. 23, 2015, 3:32 PM), <http://www.reuters.com/article/2015/01/23/atlantic-city-ratings-idUSL4N0V255X20150123> [<http://perma.cc/KQ5B-DJ8K>] (noting that Governor Christie's order to consider a restructuring for Atlantic City "marks a 'rapid, dramatic' change from" New Jersey's strong oversight of its local governments); Joel R. Spivack, *Governor Christie Warns Pensions May Force NJ into Bankruptcy*, LAW OFF. JOEL R. SPIVACK (July 24, 2014), <http://www.spivacklaw.com/blog/governor-christie-warns-pensions-may-force-nj-into-bankruptcy/> [<http://perma.cc/B4EU-LT8U>]; *Why Camden, N.J., Is Still Failing Despite State Intervention*, GOVERNING (Aug. 22, 2013), <http://www.governing.com/columns/urban-notebook/col-pontiac-camden-pew-state-aid-municipal-financial-crisis.html> [<http://perma.cc/HGB5-UC7H>].

²⁹⁹ PEW CHARITABLE TRUSTS, *supra* note 212, at 42.

³⁰⁰ Matt Friedman, *Sweeney Slams Christie's Atlantic City Plan, Says Governor Plans Bankruptcy for City*, NJ.COM (Jan. 29, 2015, 11:39 AM), http://www.nj.com/politics/index.ssf/2015/01/sweeney_slams_christies_atlantic_city_plan.html [<https://perma.cc/PE9J-SYXE>].

³⁰¹ See Gillette, *supra* note 14, at 313 ("Nevertheless, there is little reason to believe that central governments, especially states, will choose optimally in determining whether or how to respond to a local fiscal crisis.").

³⁰² See Schragger, *supra* note 170, at 878.

³⁰³ See Gerald E. Frug, *Beyond Regional Government*, 115 HARV. L. REV. 1763, 1790–91 (2002) (describing a possible solution in the form of a regional legislature); *see also*

monitoring mechanism that could address fiscal inequalities and ensure that the municipalities in the region are acting in a fiscally responsible manner could serve to fill the gap if the state is unable or unwilling to intervene, or if voter attitudes disfavor state involvement.³⁰⁴ Of course, regional entities may still be subject to political pressures, which could lessen their effectiveness as problem solvers.

Still, regional coordination in some form may be valuable because municipal bankruptcy is in fact regional—its effects frequently extend beyond the boundaries of the struggling entity. Regional solutions do not necessarily have to involve every nearby city or town. Instead, a broad swath of regional coordination opportunities should be considered, including public/private partnerships or even coalitions among neighboring states.³⁰⁵ These types of coalitions are consistent with the idea of bankruptcy as a collective process and may help decrease transaction costs and quickly effectuate relief. Sharing services with nearby jurisdictions should be considered, as collaborating with more affluent communities could in turn strengthen a municipal debtor's fiscal health.

An example of regional involvement having these positive effects is the city of Detroit's creation of a regional water authority during its bankruptcy. A six-person board runs the new water authority, with appointments from the city, surrounding counties, and the state governor.³⁰⁶ The regional deal is being touted both for smoothing over relations between Detroit and its suburbs and for its ability to generate more revenue, as a bond sale from the authority would likely fetch higher rates than a bond sale from the city by itself.³⁰⁷ In short, although regional intervention in the municipal financial distress context is a relatively untested

Christopher A. Parsons et al., *Swimming Upstream: Struggling Firms in Corrupt Cities* 3 (Nov. 17, 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2526585 [<https://perma.cc/6RL2-3G9F>] (“When a region experiences a wave of financial misconduct, bank credit becomes temporarily more expensive for nearby firms.”); Megan Davies, *Michigan's Wayne County Says It Could Face Financial Crisis*, REUTERS (Feb. 5, 2015, 6:56 PM), <http://www.reuters.com/article/2015/02/05/usa-michigan-waynecounty-idUSL1N0VF2Y620150205> [<http://perma.cc/TL2J-LC3F>] (discussing the fiscal crisis in Wayne County, Michigan, where Detroit is located).

³⁰⁴ See Matthew J. Parlow, *Equitable Fiscal Regionalism*, 85 TEMP. L. REV. 49, 52–53 (2012) (discussing the benefits of what the author terms “equitable fiscal regionalism,” which seeks to distribute the cost of regional benefits throughout a metropolitan area and reverse fiscal inequality).

³⁰⁵ See Sheila A. Martin & Carolyn N. Long, *Horizontal Intergovernmental Relations in the Portland Metropolitan Region: Challenges and Successes*, 50 WILLAMETTE L. REV. 589, 591 (2014) (noting that regionalism and interlocal cooperation is often promoted as a formula for economic success).

³⁰⁶ Steven Church et al., *Detroit New Water Agency to End Suburban Standoff*, BLOOMBERG (Sept. 9, 2014), <http://www.bloomberg.com/news/print/2014-09-09/detroit-new-water-agency-to-end-suburban-standoff.html> [<http://perma.cc/R7DQ-CUPH>].

³⁰⁷ This is because the suburban counties have higher ratings from the rating agencies. *Id.*

concept, Detroit's use of regional mechanisms illustrates the potential for regional solutions to become a very powerful tool in federal bankruptcy.³⁰⁸

B. Timing and Use

In thinking about how to design and implement changes to Chapter 9, reformers must pay attention to the variances among the fiscal and political climates of states and their municipalities. Currently, Chapter 9 represents a one-size-fits-all solution to innumerable forms of crisis for a variety of municipal entities of all shapes and sizes. Chapter 9's failure to account for these variations is a key shortcoming that must be remedied if it is to function as a viable form of relief. For example, any response to a municipal fiscal crisis must take into account the effects of state policies already in place that may constrain the municipality.³⁰⁹

One way to incorporate flexibility into a new version of Chapter 9 is to consider timing. It is critical to determine when municipalities would be better off using state alternatives to bankruptcy instead of Chapter 9. Several states, such as Pennsylvania, have receivership programs designed to be utilized either before or in lieu of Chapter 9.³¹⁰ These state programs can provide more oversight mechanisms for municipalities but do not allow the municipalities to modify contracts on a nonconsensual basis.³¹¹ Because of these programs, municipalities may avoid filing for bankruptcy entirely, or they may delay filing, sometimes to their detriment.³¹² Developing "triggers" for when a municipality should seek federal relief, as some states have already done for their state insolvency programs, could help municipalities access federal relief at a time when that relief is most likely to help them.

Currently, some states, such as Louisiana and Michigan, erect so many hurdles to filing for Chapter 9 that it becomes impossible for the municipality to file for

³⁰⁸ See GERALD E. FRUG & DAVID J. BARRON, CITY BOUND: HOW STATES STIFLE URBAN INNOVATION 226 (2008) ("The question is whether a better way to combine local and collective decision making can be designed.").

³⁰⁹ See Schragger, *supra* note 170, at 877 (noting that local, state, and federal finances are intertwined).

³¹⁰ Municipalities Financial Recovery Act, 53 PA. STAT. AND CONS. STAT. ANN. § 11701.102 (West 2014).

³¹¹ Indeed, state allowance of nonconsensual modification is explicitly prohibited under § 903(1) of the Bankruptcy Code. 11 U.S.C. § 903(1) (2012).

³¹² For example, the judge in Detroit's bankruptcy has stated that Detroit waited too long to file for federal relief. Chad Halcom, *Judge Rhodes: Detroit Bankruptcy, Filed in Good Faith, Will Continue*, CRAIN'S DETROIT BUS. (Dec. 3, 2013, 9:46 AM) <http://www.crainsdetroit.com/article/20131203/NEWS/131209960/judge-rhodes-detroit-bankruptcy-filed-in-good-faith-will-continue> [<http://perma.cc/C7WU-2TYD>]; see also Mark Gillispie, *Bankruptcy Looms for Desperate Cleveland Suburb*, THE COLUMBUS DISPATCH (Dec. 29, 2014, 6:41 AM), <http://www.dispatch.com/content/stories/local/2014/12/29/bankruptcy-looms-for-desperate-suburb.html> [<http://perma.cc/P9CB-SGGN>] (observing that East Cleveland was under a state of fiscal emergency program and may have reached a point where even bankruptcy will not help it).

bankruptcy until it is well beyond most traditional forms of help, while other states have no barriers to filing at all.³¹³ In the latter states, municipalities that file for Chapter 9 run the risk that their filing will be thrown out by the court as premature. In both cases, debtors expend substantial upfront costs before their Chapter 9 cases see the light of day. Thus, part of the solution for reforming Chapter 9 may well lie in fixing the timing—recognizing when bankruptcy will best help the municipality and when other solutions will be more beneficial. Simply advocating for increased intervention at any level is useless if that intervention is too ill-timed to be of value.

To help municipalities and states strike the right balance in terms of timing, states that erect barriers to filing for Chapter 9 could do more to ensure that those barriers take the form of bankruptcy experts rather than politicians. For example, one commentator has already suggested changing Louisiana's approval process so that it is run by a neutral fiscal administrator rather than by the state's elected Bond Commission.³¹⁴ Other states with barriers to entry to Chapter 9 should consider modifying their approval processes so that more neutral bankruptcy experts are involved in the decision-making process at an earlier stage. By providing a more inclusive role for bankruptcy or municipal finance experts, states could alleviate the concern that the road to municipal bankruptcy is more a political than a fiscal process. For example, politicians may hesitate for too long to file for bankruptcy out of concern that they will face the blame for the city's financial condition. Alternatively, politicians may jump into bankruptcy too soon, seeing it as the solution to all of their problems or, at the least, as a scapegoat for the criticisms leveled at them by their constituents. Importantly, these experts need not replace politicians, but giving experts an increased advisory role may help municipal officials better determine when seeking federal relief is appropriate.

Even if increasing the role of expert advisors is not feasible, experts may be able to play a monitoring role. Increased monitoring at either the pre- or post-bankruptcy level (or, preferably, at both points in time) may also help to alleviate many of the problems that currently characterize Chapter 9. Monitoring by a neutral bankruptcy expert may help reduce some of the politics and interest group pressures that can come into play, making it easier for the municipality to regain its footing post-bankruptcy. Increased monitoring can also help to shore up a municipality's financial position, and post-bankruptcy monitoring in particular may even make the bankruptcy process cost justified for the municipality, as it continues to receive assistance in the form of advice and oversight after it emerges from Chapter 9.

V. CONCLUSION

There is no easy solution to combat the problems of municipal financial distress. If federal bankruptcy is to remain an option for doing so, however, it is in need of reform. Over twenty years ago, a call went out to reform the municipal

³¹³ See, e.g., Wolfe, *supra* note 104, at 556–57 (describing Louisiana's many barriers to filing).

³¹⁴ *Id.* at 582.

bankruptcy system—a call that, by and large, has been ignored.³¹⁵ By analyzing a series of recent Chapter 9 filings, this Article has provided concrete evidence of the need for reform and has identified primary concerns to address in thinking about the next phase of municipal bankruptcy. Studying the cities and towns that are going through or have emerged from Chapter 9 provides important insights and critical examples of Chapter 9's shortcomings. A close examination of these cities' journeys through bankruptcy illustrates how and why Chapter 9, in its current incarnation, fails to function as an ideal bankruptcy relief mechanism.

By studying the difficulties municipalities have encountered in utilizing Chapter 9, policymakers can make more informed decisions about the future of bankruptcy law more generally. By identifying Chapter 9's functional shortcomings, this Article should help policymakers think through whether and how bankruptcy law should be applied to new areas. For example, the work assimilated in this Article should be useful in evaluating recent proposals to utilize bankruptcy to address the difficulties encountered by states,³¹⁶ territories,³¹⁷ and large financial institutions.³¹⁸

This Article lays the groundwork for future examination into comprehensive reform of Chapter 9 bankruptcy. Studying what has gone wrong with municipal bankruptcies over the years allows for a more accurate evaluation of proposed solutions to combating the problem of municipal financial distress. This Article's examination of how Chapter 9 has fallen short of helping cities out of their distress clearly indicates that it is time to formulate more appropriate mechanisms to bolster Chapter 9 relief for struggling cities and towns.

³¹⁵ See McConnell & Picker, *supra* note 8, at 494 (“[W]e believe that federal bankruptcy law [for municipalities] warrants serious reexamination.”).

³¹⁶ See generally Skeel, *supra* note 23, at 677 (discussing pros and cons of state bankruptcy).

³¹⁷ See James Surowiecki, *Why Congress Should Let Puerto Rico Declare Bankruptcy*, NEW YORKER (July 1, 2015) <http://www.newyorker.com/business/currency/why-congress-should-let-puerto-rico-declare-bankruptcy> [<http://perma.cc/UW8R-TSFM>].

³¹⁸ See, e.g., Financial Institution Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2014); see also Diane Davis, *House Panel Considers Draft Bill Providing Orderly Liquidation of Large Financial Firms*, 26 BANKR. L. REP. (BNA) 945, 949–50 (2014) (describing bankruptcy approaches to accommodate struggling financial institutions).